[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY (AND PROPOSED PROTOCOL) BETWEEN THE UNITED STATES AND THE KINGDOM OF SPAIN

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON JUNE 14, 1990

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed income tax treaty, as modified by the proposed protocol, between the United States and the Kingdom of Spain ("Spain"). The proposed treaty and proposed protocol were both signed on February 22, 1990. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty (and protocol) on June 14, 1990.

No income tax treaty between the United States and the Kingdom of Spain is in force at present.

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty (the "U.S. model"), and the model income tax treaty of the Organization for Economic Cooperation and Development (the "OECD model"). However, the proposed treaty contains certain deviations from those documents.

The first part of the pamphlet summarizes the principal provisions of the proposed treaty and protocol. The second part presents a discussion of issues that the proposed treaty presents. The third part provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. This is followed in part four by a detailed, article-by-article explanation of the proposed treaty and protocol.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and the Kingdom of Spain* (JCS-17-90), June 13, 1990.

I. SUMMARY

In general

The principal purposes of the proposed income tax treaty between the United States and Spain are to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty provides that a country will not tax business income derived from sources within that country by residents of the other country unless the business activities in the first country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 15). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country are not required to pay tax in that other country unless their contact with that country exceeds specified minimums (Articles 15, 16, and 19). The proposed treaty provides that dividends, interest, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally are taxable by both countries (Articles 10, 11, 12 and 13). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10, 11 and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit (Article 24).

The proposed treaty contains a "saving clause" similar to that contained in other U.S. tax treaties (Article 1(3)). Under this provision, the United States generally retains the right to tax its citizens and residents as if the treaty had not come into effect. In addition, the proposed treaty contains the standard provision that it does not apply to deny a taxpayer any benefits he is entitled to under the domestic law of the country or under any other agreement between the two countries (Article 1(2)); that is, the treaty only applies to the benefit of taxpayers.

The proposed treaty also contains a non-discrimination provision (Article 25) and provides for administrative cooperation and exchange of information between the tax authorities of the two countries to avoid double taxation and to prevent fiscal evasion with respect to income taxes (Articles 26 and 27).

Differences between proposed treaty and other treaties

The proposed treaty differs in certain respects from other U.S. income tax treaties, and from the U.S. model and OECD model treaties. Some of these differences are as follows:

(1) The U.S. model specifically does not limit the application of the accumulated earnings tax and the personal holding company tax. Provision 2 of the proposed protocol provides for only limited exemptions from these taxes. With respect to the personal holding company tax, a Spanish company is granted exemption for a taxable year only if all of its stock is owned for the entire taxable year by one or more individuals who are neither U.S residents nor U.S. citizens. In the case of the accumulated earnings tax, exemption is granted to a Spanish company only if it meets the publicly traded company exception contained in the article on limitation on benefits (Article 17) of the proposed treaty.

(2) The definition of the term "United States" as contained in the proposed treaty generally conforms to the definition provided in the U.S. model. In both treaties the term generally is limited to the United States of America, thus excluding from the definition U.S. possessions and territories. Provision 3 of the proposed protocol, however, explains that the United States and Spain have agreed to initiate, as soon as possible, the negotiation of an additional protocol to extend application of the proposed treaty to Puerto Rico.

In addition, the proposed treaty makes it clear that each country includes its continental shelf, whereas the U.S. model is silent with respect to this point.

(3) U.S. citizens who are not also U.S. residents are not generally covered by the proposed treaty. The U.S. model does cover such U.S. citizens. The United States rarely has been able to negotiate coverage for nonresident citizens, however.

(4) Both the proposed treaty and the U.S. model provide that a person who is taxable under the laws of a country by reason of that person's residence is considered a resident of that country for treaty purposes. Provision 5(a) of the proposed protocol limits the application of this rule in the case of certain persons who are treated as U.S. residents under the Code. That provision states that a U.S. citizen or alien admitted to the United States for permanent residence (i.e., a "green card" holder) is considered a resident of the United States for purposes of the proposed treaty only if that individual either has a substantial presence in the United States or would be a U.S. resident (and not a resident of another country) under the criteria of the tie-breaker rule, which deal with the place of a person's permanent home, center of vital interests, and habitual abode. This provision of the proposed protocol is to be administered in the same order of priority as specified in the tie-breaker rule.

(5) Under the U.S. model, a dual resident corporation is automatically considered a resident of the country under whose laws it

was first created and is, thus, entitled to only the treaty benefits that other corporate residents of that country receive.[2] Under the proposed treaty, by contrast, the determination of a single country of residence for a company that is a resident of both countries is effected through mutual agreement by the competent authorities of the two countries. The proposed treaty further provides that in situations where the competent authorities are unable to agree upon a determination of a company's country of residence, the company is treated as a resident of neither the United States nor Spain except for the limited purpose of taxing payments of dividends, interest, and royalties made by the company. This means, for example, that if a dual resident company pays a dividend to a Spanish resident, the U.S. withholding tax on that dividend is limited by the proposed treaty. Conversely, if that same company paid a dividend to a resident of the United States, the Spanish withholding tax on that dividend likewise is limited by the proposed treaty.

(6) The definition of permanent establishment in the proposed treaty is somewhat broader than that in the U.S. model, the OECD model, and in some existing U.S. treaties. The principal area in which the proposed treaty departs from the U.S. model is the inclusion as a permanent establishment of a drilling rig or ship that is used for more than six months for the exploration or exploitation of natural resources (rather than the U.S. or OECD models' 12 months).

(7) The proposed treaty omits the standard treaty provision found in the U.S. model which provides investors in real property in the country not of their residence with an election to be taxed on such investments on a net basis. The OECD model does not provide for such a net-basis election. Current U.S. law independently provides a net-basis taxation election to foreign persons (Code secs. 871(d) and 882(d)). It is understood that Spain taxes real property income on a net basis if the property is attributable to a permanent establishment or fixed base and such income is part of the business income of such permanent establishment or fixed base. Otherwise, the income arising from that property is considered passive investment income under Spanish law and is subject to a 25-percent gross basis withholding tax.

(8) The proposed treaty contains a provision not found in the U.S. or OECD models or in most other U.S. treaties that is intended to permit Spain to tax imputed rental income in certain cases where real property owned by a company or other entity is made available to an owner of shares or other rights in that company or entity. For example, where a U.S. person is a shareholder in a Spanish company which owns real property located in Spain, and that U.S. person is permitted use of that property, Spain, in accordance with its domestic law, may tax the imputed rental value of the property either to the company or to the shareholder.

(9) The proposed treaty provides clarification in a number of instances with respect to the ability of a country to tax profits derived by a business enterprise or derived from the performance of independent personal services. Specifically, the proposed treaty

[2] Under the OECD model a dual resident corporation is automatically considered a resident of the country in which its place of effective management is situated.

states that such profits may, in certain cases, be taxed by a country in which an enterprise carries on *or has carried on* business or where a person performs *or has performed* services. This clarifies that Code section 864(c)(6) is not overridden by the proposed treaty.

(10) The proposed treaty does not contain a definition of the term "business profits," although certain categories of business profits are defined in various articles. Although the OECD model does not contain a definition of business profits, many U.S. treaties, and the U.S. model, define the term business profits to include income from rental of tangible personal property and from rental or licensing of films or tapes. The proposed treaty includes payments for the use of, or the right to use, these specific items as royalties, which generally are subject to an 8-percent source-country withholding tax imposed on a gross basis.

(11) Similar to the OECD model, the article on associated enterprises (Article 9) of the proposed treaty omits the provision found in the U.S. model treaty and in most other U.S. treaties which clarifies that neither treaty country is precluded from the use of any domestic law which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between persons, whether or not residents of one of the treaty countries, owned or controlled directly or indirectly by the same interests, where necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons. It is understood, however, that the United States is entitled under the proposed treaty to utilize the rules of Code section 482 in cases where it is necessary to reallocate profits among related enterprises to reflect results which would prevail in a transaction between independent enterprises.

(12) The proposed treaty's limits on gross-basis dividend withholding tax rates that the country of source may impose differ from those of the U.S. model. Both treaties provide for two levels of limitation. With respect to the proposed treaty, these levels are, in general: 10 percent in the case of dividends paid to a 25-percent or more corporate owner, and 15 percent in other cases. These limitations contrast with the five percent limit on dividends paid to 10-percent or more corporate owners and the 15-percent limit on other dividends contained in the U.S. model.

(13) Generally, the proposed treaty, the U.S. model, and the OECD model all share a common definition of the term "dividends." [3] The proposed treaty further defines this term, however, to include income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the local law on the country in which the income arises. That is, each country is to apply its domestic law, for example, in differentiating dividends from interest.

Additionally, provision 7(a) of the proposed protocol contains a modification to the definition of dividends. Under that provision, dividends include profits on a liquidation of a company which is a

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[3] That definition is "income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident."

resident of one of the countries. The provision does not specify whether the amount to be treated as a dividend is the amount of earnings and profits of the liquidating corporation, or if it is limited to the amount of gain recognized by the shareholder (or shareholders) as a result of the liquidation. Because a treaty generally is used only to the benefit of a taxpayer, characterization of a liquidating distribution as a dividend would not apply in cases where dividend treatment would yield a greater amount of tax than would the treatment of a liquidation generally prescribed under applicable local law. For example, where a Spanish individual disposes of the stock of a U.S. corporation pursuant to a liquidation of that company, U.S. law generally does not subject the disposition to tax. (Tax is imposed on such a disposition only in cases where the individual is present in the United States for at least 183 days during the taxable year, where the corporation is a U.S. real property holding corporation, or where the gain resulting from the disposition is effectively connected with the conduct of a U.S. trade or business.)[4] By contrast, treatment of the gain as a dividend would result in the imposition on the shareholder of either a 10- or 15-percent tax under the proposed treaty; thus, providing a detrimental result to the shareholder.

Finally, the proposed treaty, as amended by provision 7(d) of the proposed protocol, prescribes a maximum withholding rate of 15 percent on dividends if those dividends are paid by a regulated investment company (RIC), regardless of whether the RIC dividends are paid to a direct or portfolio investor. The proposed treaty does not permit a reduction of U.S. withholding tax on dividends if those dividends are paid by a real estate investment trust (REIT), unless the dividends are beneficially owned by an individual holding a less than 25-percent interest in the REIT. The Senate recently gave advice and consent to protocols with France and Belgium on the understanding that provisions be negotiated with those countries permitting withholding rates on RIC and REIT dividends higher than the rates provided for in general by the U.S. treaties with those countries.

(14) The proposed treaty generally limits the rate of withholding tax at source on gross interest to 10 percent. As an exception to this general rule, interest derived by the governments of the countries, derived by financial institutions on certain long-term loans, or paid in connection with the sale on credit of industrial, scientific, or commercial equipment is exempt from source country withholding tax. The OECD model also permits the source country to tax interest as a rate of up to 10 percent. Under the U.S. model, all interest generally is exempt from source country withholding tax.

Because of the repeal in the Tax Reform Act of 1984 (the "1984 Act") of the U.S. gross withholding tax on interest paid on portfolio indebtedness held by foreign persons, Spanish residents generally receive U.S. source interest on portfolio indebtedness free of U.S. tax in any event. U.S. residents, on the other hand, generally are

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[4] In addition, legislation has been introduced in Congress that would tax as effectively connected income gains derived by foreign persons from the disposition of U.S. stock in cases where the foreign person held at least a threshold amount (i.e., 10 percent) of the stock of the U.S. corporation (H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989); H.R. 4308, sec. 201, 101st Cong. 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess. (1990)).

subject to Spanish tax (limited to 10 percent by the treaty) on Spanish source interest on similar indebtedness.

In addition, the proposed treaty permits each country to impose a branch-level interest tax on certain amounts of interest expense deducted by a permanent establishment located in that country of a corporation resident in the other country. The rate of branch-level interest tax that may be imposed by a country is limited by the proposed treaty to 10 percent (5 percent in the case of interest of a bank).

(15) The proposed treaty allows source-country taxation of royalties at rates ranging from 5 to 10 percent. Both the U.S. and OECD models exempt royalties from source-country tax. In addition, the proposed treaty includes in the definition of royalties payments of any kind received in consideration for the use of, or the right to use, industrial, commercial, or scientific equipment. Such payments are not treated as royalties under the U.S. model. Rather, they generally are subject to the provisions of the business profits article of that treaty (Article 7).

(16) Although not found in the OECD model, the U.S. model, or many other U.S. treaties, the proposed treaty contains a special provision for determining the source of royalties. This provision only applies for purposes of determining whether royalties are taxable in the source country; it is not applicable in determining the source of royalties for purposes of computing the foreign tax credit under the article on relief from double taxation (Article 24). The special sourcing provision includes four separate rules. First, if the payor of a royalty is the government of one of the treaty countries (or political subdivision or local authority thereof), then the royalty is sourced in that country. Second, if the royalty is paid by a person, whether or not a resident of one of the two countries, who has a permanent establishment or fixed base in one of the countries in connection with which the liability to pay the royalty arose, and if the royalty is actually borne (i.e., is deducted in computing taxable income) by that permanent establishment or fixed base, then the royalty is sourced in the country in which the permanent establishment or fixed base is located. Third, if a royalty is not borne by a permanent establishment or fixed base located in one of the countries, then it is sourced in the country of the payer's residence (as determined under the proposed treaty). Fourth, where the person paying a royalty neither is a resident of, nor has a permanent establishment or fixed base in, one of the countries, but the royalty relates to the use of (or right to use) property in one of the countries, then the royalty is sourced in the country where such property is used. Similar source rules for royalties are contained in the U.S. treaties with Australia and New Zealand.

By contrast, since the U.S. model does not specifically provide (for any purpose) a sourcing rule for royalties, the applicable rule of domestic law applies. With respect to the domestic law of the United States, royalties generally are sourced in the country where the property giving rise to the royalty is used (Code sec. 861(a)(4)).

(17) In general, the U.S. model, the OECD model, and the proposed treaty all permit the source country to tax gains in the limited situations involving dispositions of either real property interests or personal property associated with a permanent establishment or

fixed base. Unlike the model treaties, the proposed treaty extends the right of a source country to tax gains in certain cases where a resident of the other country disposes of stock, participations, or other rights in the capital of a company or other entity that is a resident of the first country. The source country may tax such gains only where the person disposing of the specified asset had a direct or indirect participation of at least 25 percent of the capital of the company or entity during the prior 12-month period. Under present U.S. law, the United States would not subject to tax such a disposition by a Spanish resident of the stock of a U.S. company. Legislation has been proposed, however, which would require the imposition of such a tax.[5]

(18) The limitation on benefits articles in the U.S. model and in the proposed treaty have certain dissimilarities. The U.S. model generally provides entitlement to treaty benefits only to entities (a) that are more than 75 percent beneficially owned by individual residents of the country of residence of the entity;[6] and (b) that do not use a substantial portion of their income to meet liabilities of persons who are not residents of either treaty country and who are not U.S. citizens (a "base erosion" rule).

In addition, the U.S. model contains two special rules. First, the general rules discussed above do not apply if it is determined that the principal purpose behind the acquisition or maintenance of an entity and the conduct of its operations was not to obtain treaty benefits. Second, the U.S. model specifies that no treaty relief is granted by one country to a resident of the other country to the extent that, under the domestic law of that other country, the income to which the relief relates bears significantly lower tax than similar income arising in the other country derived by its residents. Although the proposed treaty contains a rule that is similar to the first special rule, it does not contain a provision similar to the second special rule.

The proposed treaty enumerates a number of persons that are entitled to treaty benefits. A person not specifically mentioned in this article may not obtain benefits under the treaty unless that person is able to demonstrate to the competent authority of the country in which income arises that the granting of treaty benefits is warranted in that person's particular case.[7] The persons listed in the proposed treaty to whom treaty benefits are extended include (a) individual residents of either treaty country, (b) the government of either country (including political subdivisions or local authorities thereof), (c) certain not-for-profit organizations, (d) other tax-exempt organizations provided that more than half of the beneficiaries, members, or participants in such organizations are entitled to treaty benefits under this article, (e) certain publicly traded companies, and (f) companies that are more than 50 percent beneficial-

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[5] Both H.R. 4308 (sec. 201, 101st Cong., 2d Sess. (1990)) and S. 2410 (sec. 201, 101st Cong., 2d Sess. (1990)) would permit the U.S. to generally impose tax on a disposition of stock of a U.S. corporation by a foreign person who owns 10 percent or more of the stock of that corporation.

[6] A company whose stock is substantially traded on a recognized exchange in one of the treaty countries is presumed owned by individual residents of that country.

[7] In making such a determination, the competent authority is to take into account the factors set forth in the first anti-abuse rule of the U.S. model discussed above (i.e., the purposes behind an entity's acquisition, maintenance, and operations).

ly owned, directly or indirectly, by persons entitled to treaty benefits or by U.S. citizens, and that meet a base erosion test similar to the one included in the U.S. model.

(19) Like the OECD model, the proposed treaty allows directors' fees derived by a resident of one country for services performed outside of that country in his capacity as a member of the board of directors of a company which is a resident of the other country to be taxed in that other country. The U.S. model treaty, on the other hand, generally treats directors' fees under other applicable articles, such as those on personal service income. Under the U.S. model (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal service income.

(20) Under the proposed treaty, a source country may tax income derived by entertainers and athletes from their activities as such, without regard to the existence of a fixed base or other contacts with the source country, if that income exceeds $10,000 in a taxable year. Under the U.S. model treaty, entertainers and athletes are so taxable in the source country only if they earn more than $20,000 there during a taxable year. Most U.S. income tax treaties follow the U.S. model rule, but use a lower annual income threshold. Under the OECD model, entertainers and athletes may be taxed only by the country of source, regardless of the amount of income that they earn from artistic or athletic endeavors.

The proposed treaty also includes an exception from source-country taxation of entertainers and athletes resident in the other country if the visit to the source country is substantially supported by public funds of the country of residence. Neither the U.S. model nor the OECD model contains such an exception.

(21) Under the U.S. model, the United States maintains exclusive rights to tax U.S. social security payments made to residents of the other country or to U.S. citizens. The proposed treaty, by contrast, permits both the U.S. and Spain to tax social security and other public pension payments. In cases where both countries tax such payments, the recipient's country of residence is required under the proposed treaty to allow relief from double taxation for any taxes imposed by the other country.

(22) The U.S. model, the OECD model, and the proposed treaty all provide a general exemption from host-country taxation of certain payments from abroad received by students and trainees who are or were resident of one country and present in the host country. Whereas the U.S. and OECD models permit this exemption without regard to any income threshold or time limit, the proposed treaty allows it only for a period not exceeding five years with respect to students, and only for a period twelve consecutive months with respect to trainees. The proposed treaty also exempts researchers on the same basis, and exempts certain grant receipts from wherever they may arise. In addition, the proposed treaty limits the exemption for trainees to an aggregate amount of income not in excess of $8,000.

The proposed treaty also permits an exemption from host-country tax for up to fixed amounts of personal services income earned by certain visiting students and others. Neither the U.S. model nor the OECD model contain such an exemption.

(23) The U.S. model provides certain specific sourcing rules for purposes of computing the foreign tax credit. For example, under the U.S. model, income derived by a resident of one country which is taxable in the other country pursuant to the treaty (other than solely by reason of citizenship) is sourced in that other country. Moreover, income derived by a resident of one of the countries which is not taxable by the other country is sourced in the taxpayer's country of residence.

The proposed treaty only provides one foreign tax credit source rule, which has limited application. Under that rule, in the case of a U.S. citizen who is a resident of Spain whose income is taxable by the United States by reason of that person's citizenship (i.e., income that is taxed by the United States under the saving clause), such income is deemed to arise in Spain to the extent necessary to avoid double taxation. In all other cases, the source rules of applicable domestic law shall apply.

(24) Under the proposed treaty's mutual agreement procedure rules, a case must be presented for consideration to a competent authority within five years from the first notification of the action resulting in taxation not in accordance with the provisions of the proposed treaty. The U.S. model does not specify any time limit for presentation of a case to a competent authority, whereas the OECD model provides a three-year time limit for this purpose.

(25) The proposed treaty's exchange of information provision contains some differences from the U.S. model. The U.S. model provides for the exchange of information relating to taxes of every kind imposed by the two countries. The proposed treaty provides for the exchange of information only as it is relevant to the assessment of taxes covered by the treaty. The U.S. model requires that, upon an appropriate request for information, the requested country obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. It also requires that, where specifically requested by the competent authority of one country, the competent authority of the other country provide the information in the form requested. The proposed treaty does not include these requirements.

(26) Unlike either the U.S. or OECD model treaties, the proposed treaty, as amended by provision 10(b) of the proposed protocol, permits a country to tax, in accordance with its internal law, gains from the alienation of (i.e., removal of) personal property which are attributable to a permanent establishment that an enterprise of the other country has or had in the first country. Tax may be imposed by that country, however, only on the amount of the gain that has accrued at the time of the property's removal from that country. Moreover, the proposed treaty provides that gain may be taxed in the other country, in accordance with its law, but only to the extent of the gain accruing subsequent to the time of removal from the first country. It is understood that this provision represents a compromise between the Spanish custom of taxing accrued, but unrealized gains at the time the asset is removed from Spain, with the U.S. rules under Code section 864(c)(7), which generally permits the United States to tax the realization of gains from the disposition of property that formerly was part of a U.S. business. This rule of the proposed treaty is subject to the saving clause.

(27) The U.S. model provides rules regarding tax collection assistance to be provided to one treaty country by the other treaty country. Specifically, the U.S. model provision states that each treaty country shall endeavor to collect on behalf of the other treaty country such amounts as may be necessary to ensure that treaty-relief granted from taxation generally imposed by that other country does not inure to the benefit of persons not entitled thereto. Neither the proposed treaty nor the OECD model contain similar clauses.

II. ISSUES

The proposed treaty, as amended by the proposed protocol, presents the following specific issues.

(1) Treaty shopping

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty is intended to benefit residents of Spain and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source-country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of U.S. tax on interest by lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing a subsidiary, trust, or other investing entity in that treaty country, which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty shopping provision of the proposed treaty is similar to an anti-treaty shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties, including the treaties that are the subject of this hearing. Some aspects of the provisions, however, differ either from the corresponding provision of the U.S. model or from the anti-treaty shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. An issue, then, is whether the proposed anti-treaty shopping provisions effectively forestall potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed treaty is more lenient than the comparable rule in the U.S. model and other U.S. treaties. The U.S. model allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the company's country of residence, while the proposed treaty (like several newer treaties and an anti-treaty shopping provision in the Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country, citizens of the United States, and certain other specified persons. Thus, this safe harbor is considerably easier to enter, under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed; that is, ownership by third-country

residents attempting to obtain treaty benefits. In addition, a base erosion test contained in the proposed treaty provides protection from certain potential abuses of a Spanish conduit.

Another item contained in the proposed treaty's anti-treaty shopping rules differs from the U.S. model. This provision permits an entity, not otherwise authorized to obtain treaty benefits, to obtain benefits under the proposed treaty if it can demonstrate to the competent authority of the country in which the income in question arises that such person is deserving of treaty benefits. The proposed treaty states that in making its determination whether or not to extend treaty benefits, the competent authority of the relevant country shall take into account, among other things, whether the establishment, acquisition, and maintenance of the entity, and the conduct of its operations, did not have as one of its principal purposes the obtaining of benefits under the proposed treaty. A rule of the U.S. model, on the other hand, provides that treaty benefits *shall not be limited* if it is determined that the acquisition or maintenance of the entity and the conduct of its operations did not have as a principal purpose the purpose of obtaining treaty benefits. Although both provisions contain a principal purpose test, it appears that the provision of the proposed treaty grants the relevant competent authority greater opportunity to refuse treaty benefits since the principal purpose behind the establishment, acquisition, or maintenance of the entity and the conduct of its operations is just one of the factors to be taken into consideration.

The United States should maintain its policy of limiting treaty shopping opportunities whenever possible. The provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Spain; for example those investors may be unwilling to share ownership of such investing entities on an equal basis with U.S. or Spanish residents or other qualified owners in order to meet the ownership test. One concern, however, is that abuses could develop in the future. It has proven difficult to renegotiate treaties once abuses develop. Thus the Committee should satisfy itself that the provision as proposed is an adequate tool for preventing possible future treaty-shopping abuses.

(2) Treatment of construction projects and drilling rigs as permanent establishments

The proposed treaty contains a permanent establishment article that is broader than that contained in the U.S. or OECD model. This article permits the country in which the activities are carried on to tax the activities sooner than it would be able to under either model treaty. Under the proposed treaty, U.S. enterprises carrying on activities in connection with a building site, construction or installation project, or an installation or drilling rig used for exploration for and exploitation of natural resources may be subject to Spanish tax if they are present in Spanish territory for as little as six months in any twelve-month period. This treatment contrasts with the general twelve-month permanent establishment rules of the U.S. and OECD models. The practical effect of this provision could be to increase Spanish taxation of construction and mineral exploration activities. On the other hand, this rule also permits in-

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creased U.S. taxation of domestic construction and mineral exploration activities conducted by Spanish residents.

(3) Treatment of equipment rentals

In addition to containing the traditional definition of royalties which is found in most U.S. tax treaties (including the U.S. model), the proposed treaty provides that royalties include payments for the use of, or the right to use, industrial, commercial, or scientific equipment. These payments are often considered business profits by other treaties, subject to rules which generally permit the source country to tax such profits only if they are attributable to a permanent establishment located in that country. In such case, the tax is computed on a net basis. By contrast, the proposed treaty permits gross-basis source-country taxation of these payments, at a rate not to exceed 10 percent, if the payments are not attributable to a permanent establishment situated in the source country. If the payments are attributable to such a permanent establishment, then the business profits article of the proposed treaty applies and the income is taxed on a net basis in the source country. The issue is whether or not it is appropriate to permit a source country to impose a gross basis tax on payments for the use (or right to use) these items in cases where the taxpayer does not maintain a permanent establishment in that country.

(4) Insurance excise tax

Similar to the U.S. model treaty, the proposed treaty covers the U.S. excise tax on insurance premiums paid to foreign insurers. Thus, for example, a Spanish insurer or reinsurer without a permanent establishment in the United States can collect premiums on policies covering a U.S. risk or a U.S. person free of this tax. However, the tax is imposed to the extent that the risk is reinsured by the Spanish insurer or reinsurer with a person not entitled to the benefits of the proposed treaty or another treaty providing exemption from the tax. This latter rule is known as the "anti-conduit" rule.

Prior waivers of the excise tax have raised serious Congressional concern. For example, concern has been expressed over the possibility that they may place U.S. insurers at a competitive disadvantage to foreign competitors in U.S. markets, if insubstantial tax is imposed by the other country to the treaty (or any other country) on the insurance income of its residents (or the income of companies with which they reinsure their risks). Moreover, in such a case, waiver of the tax does not serve the purpose of treaties to avoid double taxation, but instead has the undesirable effect of eliminating all taxation.

The U.S.-Barbados and U.S.-Bermuda tax treaties each contained such a waiver as originally signed. In its report on the Bermuda treaty, the Foreign Relations Committee expressed the view that such waivers should not have been included. The Committee stated that waivers should not be given by Treasury in its future treaty negotiations without prior consultations with the appropriate committees of Congress. Congress subsequently enacted legislation to ensure the sunset of the waivers in the two treaties. The waiver of the tax in the treaty with the United Kingdom (where the tax was

waived without the so-called "anti-conduit rule") has been followed by a number of legislative efforts to redress perceived competitive imbalance created by the waiver.

The proposed treaty waives imposition of the excise tax on premiums paid to residents of Spain. Unlike Bermuda and Barbados, Spain imposes substantial tax on income, including insurance income, of its residents. Unlike the U.K. waiver, moreover, the waiver in the proposed treaty contains the standard anti-conduit language. Moreover, Spanish internal law imposes a similar tax on insurance and reinsurance premiums derived in Spain by foreign companies. This tax is reciprocally waived in the proposed treaty with respect to U.S. insurers. For these reasons, waiver of the U.S. excise tax on insurance in the present case is distinguishable from those previous cases in which Congress has raised objections.

The Committee may wish to assure itself that the practical effect of the waiver of this tax in the treaty is, in fact, to reduce double taxation, rather than to give Spanish insurers competing in the U.S. market a generally more favorable overall tax burden than their U.S. counterparts.

(5) U.S. taxation of stock gains of certain foreign persons

The United States does not currently impose tax on U.S. source noneffectively connected capital gains of nonresident individuals and foreign corporations, with two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real estate. The treaty provides that gains of Spanish residents are exempt from U.S. tax unless they are (1) gains from the disposition of U.S. real property interests; (2) gains from the alienation of personal property which forms or formed part of the business property of a permanent establishment or a fixed base in the United States; (3) gains from the alienation of a right or property which are contingent on the productivity, use, or disposition thereof; or (4) gains from the disposition of stock of a U.S. corporation if the recipient of the gain was at least a 25-percent owner of that corporation within the 12-month period immediately preceding the disposition. Thus, if a Spanish person without a U.S. permanent establishment or fixed base owns less than 25 percent of the stock in a U.S. corporation, any gains from the disposition of that stock generally will be exempt from U.S. tax under the treaty, regardless whether U.S. internal law is changed to provide for such a tax, unless that change was specifically intended to override existing treaties.

In 1989, the House of Representatives passed a bill that would have taxed the gain on a disposition by a foreign person of stock in a U.S. corporation if the foreign person holds or held more than 10 percent of the stock of the U.S. corporation at any time during the 5 years prior to the disposition.[8] This provision, had it been enacted into law, would have yielded to contrary existing treaties for a 3-year period and then overridden them subsequently. In the committee report on this provision, however, it was anticipated

[8] H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989). The provision was deleted in conference.

that in some cases, it could have been desirable for the United States to enter into treaties that would modify the effect of the provision on treaty country residents.

The override provision was considered by the Administration to be a crippling defect in the bill, putting aside the more basic tax policy question whether such gains of foreign persons should be exempt in all cases from U.S. tax, when dividends paid by U.S. corporations to foreign corporations are not, or whether it would not be more appropriate to tax gains no more favorably than dividends.

Bills have been introduced this year in both Houses of Congress that would tax as effectively connected income gains derived by foreign persons from the sale of stock of domestic corporations in cases where the foreign person holds or held at least 10 percent of the stock of the domestic corporation.[9] Unlike the unsuccessful House bill provision of 1989, the 1990 bills generally do not override existing contrary treaties.

Thus, if the 1990 bill were enacted, the proposed treaty would prevent the operation of U.S. law that would otherwise tax U.S. stock gains derived by a Spanish person who owned between 10 and 25 percent of the U.S. company's stock during the prior 12-month period, or owned less than 10 percent during that period, but owned at least 10 percent at any time during the four years preceding that period.

The issue is whether it is advisable to enter into a treaty that would limit in this way the operation of a tax that the Congress may decide to impose as the result of a change in its internal tax law policy. Although prior Congresses may have believed that the gains realized by foreign persons from the disposition of stock in U.S. companies were properly excluded, as a statutory matter, from the U.S. tax base, whether for reasons of administrability or for other reasons, Congress may decide that it is no longer appropriate to do so in the case of substantial foreign shareholders in U.S. stock. The Congress could further decide that, just as it is inappropriate in treaties to reduce source country taxation of dividends to zero, it is similarly inappropriate to reduce to zero the rate of tax on gains from stock that pays such dividends, or that it is inappropriate to reduce such tax to zero in all cases and for all types of dispositions.

Alternatively, the Congress could decide that, while a tax on stock gains should be imposed by statute, it may properly be modified in some treaties.[10]

The Committee should be aware that by accepting the proposed treaty in its present form, it would be foreclosing the option to tax Spanish persons to the full extent of the 1990 bills' provisions were they enacted into law. However, the Committee may determine that even if Congress enacts a tax on foreigners' stock gains, a

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[9] H.R. 4308, sec. 201, 101st Cong., 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess. (1990).

[10] "The committee anticipates that in some cases it may be desirable for the United States to enter into treaties that would modify the effect of the provision on treaty country residents. For example, in a case where the treaty country imposes a similar tax subject to a 25-percent threshold rather than a 10-percent threshold, the committee anticipates that it may be appropriate for the United States to enter into a treaty exempting those treaty country residents who are not at least 25-percent shareholders in a domestic corporation, assuming as well that the persons obtaining relief under such a treaty are subject to tax that would be imposed by the bill." H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 1314 (1989).

moderate restriction on operation of the statute, such as the one contained in the proposed treaty, is not inappropriate.

(6) Exchange of information

The exchange of information article contained in the proposed treaty is very similar to the corresponding article of the OECD model treaty. The exchange of information article of the U.S. model, as compared to that article in the OECD model (and in the proposed treaty) provides for a somewhat broader scope of information exchange. For example, the U.S. model contains a provision, not found in the OECD model or in the proposed treaty, that places a requirement on the competent authority of a treaty country to obtain the information requested by the other competent authority "in the same manner and to the same extent" as if the tax of the requesting country was its own tax and was being imposed by it. Such a provision is intended to establish a reciprocal commitment on behalf of each treaty country to make available to the other country its investigative authority and procedures as mandated under its domestic law in order to obtain the information sought by the other country. Provision 19(a) of the proposed protocol, however, provides that the exchange of information article of the proposed treaty is to be interpreted consistently with the Commentary on Article 26 of the 1977 OECD model convention. That commentary, in part, provides that although a treaty country is not bound to go beyond its own internal laws and administrative practice in putting information at the disposal of the other country, types of administrative measures that are authorized for that country's tax must be utilized, even though invoked solely to provide information to the other treaty country. Furthermore, internal provisions concerning tax secrecy should not be interpreted as constituting an obstacle to the exchange of information under the OECD model. The OECD commentary also states that information is deemed to be obtainable in the normal course of administration if it is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax determination. This means that the requested country has to collect the information the other country needs in the same way as if its own taxation was involved. It is possible that these (combined with other) items from the OECD commentary regarding exchange of information result in the provision contained in the proposed treaty being very close to the omitted portion of the U.S. model referred to above.

The provision of the U.S. model further places a requirement on each treaty country, if requested by the other country, to provide information in the form of depositions of witnesses and authenticated copies of unedited original documents, including books, papers, statements, records, accounts, or writings, to the same extent that such depositions and documents are obtainable under its internal laws and administrative practices and procedures with respect to its own taxes. This part of the U.S. model's exchange of information article is intended to assure that evidence can be obtained in a form admissible for purposes of litigation.

A third difference between the U.S. model and the proposed treaty (and OECD model) is that the U.S. model contains a clause that requires each treaty country to assist in the collection of taxes

to the extent necessary to ensure that treaty benefits provided by the other country are enjoyed only by persons entitled to those benefits under the treaty. In providing such assistance, the U.S. model does not impose on the other country an obligation to carry out administrative measures that are at variance with its internal measures for tax collection, or that are contrary to its sovereignty, security, or public policy. Assistance in collection can be useful, for example, in a case where an entity located in a country with which the United States has a treaty serves as a nominee for a third-country resident. If the entity, on behalf of the third-country resident, receives a dividend from a U.S. corporation with respect to which a reduced rate of tax (as provided for by the treaty) is inappropriately withheld, the entity, as a withholding agent, is technically liable to the United States for the underpaid amount of tax. However, without assistance from the government of the treaty country in which the entity is resident, enforcement of that liability may be difficult.

A fourth item which causes the U.S. model's exchange of information provisions to be more expansive than the corresponding provisions of the other two treaties is that the model's provisions are made specifically applicable to taxes of every kind imposed at the national level, notwithstanding the limitations contained in the taxes covered article of the treaty. A provision of this type permits, for example, information exchanges regarding estate taxes even though general application of the treaty does not extend to those taxes.

The issue is whether the Committee views the exchange of information rules contained in the proposed treaty as sufficient to carry out the tax-avoidance purpose for which income tax treaties are entered into by the United States. With respect to the form of the information provided, it will be preferable for the United States to be able to obtain information from Spain in the forms specified in the U.S. model treaty. Due to the proposed protocol's reference to the OECD Commentary on Article 26 of the OECD model treaty, the proposed treaty may provide some assurance that Spain will take whatever measures are possible under its tax laws to obtain information for the benefit of the United States.

With respect to the absence of a reciprocal tax collection provision, the Committee may wish to consider the extent to which absence of such a provision adversely affects U.S. efforts to confine Spanish treaty benefits to persons entitled to those benefits. The absence of collection assistance in this treaty also may decrease the United States' ability to obtain the desired level of collection assistance in treaty negotiations with other countries.

(7) Second-level withholding on dividends

Under current U.S. Code rules, a Spanish corporation engaged in the conduct of a trade or business in the United States would, in the absence of a treaty, be subject to a flat 30-percent branch profits tax on its "dividend equivalent amount." In a case where imposition of the branch profits tax is precluded, the Code imposes U.S. withholding tax on a portion of the dividends paid by a foreign corporation to a foreign person, if 25 percent or more of the corporation's gross income over a three-year testing period consists of

income that is treated as effectively connected with the conduct of a U.S. trade or business. The U.S. source portion of such dividend generally is equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. This so-called second-level withholding tax is only imposed in the absence of a branch profits tax because both taxes accomplish a similar objective: ensuring that, like the U.S earnings of U.S. corporations, the U.S. earnings of foreign corporations are subject to both corporate and shareholder level U.S. tax.

The proposed treaty expressly permits the United States to impose the branch profits tax on a Spanish corporation, and expressly forbids imposition of the second-level withholding tax on a dividend paid by a Spanish corporation to a Spanish resident. The proposed treaty also expressly forbids imposition of the second-level withholding tax on a dividend paid by a third-country corporation to a Spanish resident. The issue is whether this treatment of non-Spanish corporations under the Spanish treaty is appropriate.

Corporations resident in many other countries with which the United States has treaties currently are not subject to the branch tax. This is not the preferred U.S. treaty position, and the Treasury Department is in at least some cases negotiating to permit the imposition of the branch tax on residents of these companies. As of the present, however, only the U.S.-France treaty, and the treaties which are the subject of this hearing, have been modified to permit the branch tax; of these only the French treaty provision is now in effect.

In light of the number of countries which have U.S. tax treaties protecting residents from the U.S. branch tax, and in light of the purposes of the second-level withholding tax, it would seem appropriate that a dividend paid by a corporation that is resident in neither Spain nor the United States, to a resident of Spain, be subject to possible U.S. withholding tax if the corporation is not subject to the U.S. branch tax due to a treaty. Yet under the proposed treaty, for example, a Dutch company doing business in the United States can pay dividends to a Spanish resident who has no U.S. permanent establishment or fixed base without incurring U.S. branch tax *or* U.S. dividend withholding tax.

The proposed treaty can be said to be flawed insofar as it treats such a dividend no differently than it treats a dividend paid by Spanish corporation, which is subject to the U.S. branch tax. The Committee may wish to express its views toward the proper method for relieving second-level withholding tax in future treaties.

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. It also discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

The United States taxes U.S. citizens, U.S. residents, and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income that is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and certain limited classes of foreign source income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income.")

Income of a nonresident alien or foreign corporation that is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected. A foreign corporation is also subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. A foreign corporation is also subject to a branch-level interest tax, which amounts to a flat 30 percent of the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

U.S. source fixed or determinable annual or periodical income of a nonresident alien or foreign corporation (including generally interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. In the case of certain insurance premiums earned by such persons, the tax is 1 or 4 percent of the premium paid. The gross-basis tax imposed on U.S. source noneffectively connected income paid to foreign persons is collected by means of withholding (hence these taxes are often called withholding taxes).

These taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. In addition, certain statutory exemptions

from the 30-percent tax are provided. For example, interest on deposits with banks or savings institutions is exempt from tax unless such interest is effectively connected with the conduct of a U.S. trade or business. Exemptions are provided for certain original issue discount and for income of a foreign government or international organization from investments in U.S. securities. Additionally, certain interest paid on portfolio obligations is exempt from the 30-percent tax. Where the Code or treaties eliminate tax on interest paid by a corporation to certain related persons, the Code generally provides for denial of interest deductions at the corporate level to the extent that the corporation's net interest expenses exceed 50 percent of adjusted taxable income. The amount of the disallowance is limited, however, by the amount of tax-exempt interest paid to related persons.

U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real property.[11]

The source of income received by nonresident aliens and foreign corporations is determined under rules contained in the Internal Revenue Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S. source income. However, if during a three-year testing period a U.S. corporation or U.S. resident alien individual derives more than 80 percent of its gross income from the active conduct of a trade or business in a foreign country or possession of the United States, then interest paid by that corporation is foreign source rather than U.S. source. Moreover, even though dividends paid by a corporation meeting this test are U.S. source, a fraction of each dividend corresponding to the foreign source fraction of the corporation's income for the three-year period is not subject to withholding tax. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign source income. However, in the case of a dividend paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business, a portion of such dividend is considered U.S. source income. The U.S. source portion of such dividend generally is equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. (No tax is imposed, however, on a foreign recipient to the extent of such U.S. source portion unless a treaty prevents application of the statutory branch profits tax.)

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be

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[11] In addition, bills have been introduced in Congress that would tax as effectively connected income gains derived by foreign persons from the sale of stock of domestic corporations in cases where the foreign person held at least a threshold amount (i.e., 10 percent) of the stock of the domestic corporation (H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989); H.R. 4308, sec. 201, 101st Cong., 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess., (1990)).

either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

Because the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation by generally allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis. Pursuant to rules enacted as part of the Tax Reform Act of 1986 (the "1986 Act"), the overall limitation is computed separately for certain classifications of income (e.g., passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the averaging of foreign taxes on certain types of foreign source income traditionally subject to high foreign taxes against the U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on oil and gas extraction income.

Prior to the Tax Reform Act of 1984 (the "1984 Act"), a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent-or-more U.S.-owned foreign corporations only. In order to prevent a similar technique from being used to average foreign taxes among the separate limitation categories, the 1986 Act provided look-through rules for the characterization of inclusions and income items received from a controlled foreign corporation.

Prior to the 1986 Act, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient foreign tax credits and no domestic income (whether or not the taxpayer had economic income from domestic operations). In order to mandate at least a nominal tax contribution from all U.S. taxpayers with substantial economic income, the 1986 Act proved that foreign tax credits cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction). However, as amended by the Omnibus Budget Reconciliation Act of 1989, no such limitation is imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. These taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited, subject to the various separate income limitations and the overall limitation.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign source income, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation: situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation generally is accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels compara-

ble to those imposed by the source country on its residents. The treaties also provide for the elimination of double taxation by requiring the country of residence to allow a credit for taxes that the source country retains the right to impose under the treaty. In some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each of the two countries. Treaties also provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent tax and seeks to reduce or eliminate this tax in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "saving clause". Double taxation can also still arise because most countries will not exempt passive income from tax at the source. This double taxation is mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income will be exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment

income. The Internal Revenue Service (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between the countries is further assured under the treaties by the inclusion of a competent authority mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

At times, residents of countries without income tax treaties with the United States attempt to use a treaty to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, the treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

The treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that which it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against enterprises owned by residents of the other country.

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IV. EXPLANATION OF PROPOSED TAX TREATY

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and Spain (as modified by the proposed protocol) appears below.

Article 1. General Scope

The general scope article describes the persons who may claim the benefits of the proposed treaty and contains other rules, including the "saving clause" that generally allows each country to tax its citizens and residents notwithstanding the proposed treaty.

The proposed treaty applies generally to residents of the United States and to residents of Spain, with specific exceptions designated in other articles. This follows other U.S. income tax treaties, the U.S. model income tax treaty, and the OECD model income tax treaty. Residence is defined in Article 4.

The proposed treaty also contains the rule found in other U.S. tax treaties that its provisions will not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance otherwise accorded by the domestic laws of either country or any other agreement between the two countries. Thus, the proposed treaty will apply only where it benefits taxpayers. In cases where a treaty provision would have a detrimental effect on a taxpayer, the taxpayer may elect to utilize the rules of domestic law or of another agreement between the two countries.

Like all U.S. income tax treaties, the proposed treaty contains a "saving clause." Under this clause, with specific exceptions described below, the proposed treaty is not to restrict the taxation by either country of its residents or its citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are residents of Spain as if the treaty were not in force. "Residents" for purposes of the treaty (and thus, for purposes of the saving clause) include corporations and other entities as well as individuals (Article 4 (Residence)). Because Article 4 generally provides for the determination of a single residence country for persons covered by the proposed treaty, the saving clause has two effects. First, it preserves the right of a country to tax its residents in situations where exclusive taxing jurisdiction is granted (except for this clause) to the other state. Second, it preserves the right of a country to tax its citizens in situations where the citizen is treated as a resident of the other country pursuant to the proposed treaty, and exclusive taxing jurisdiction is granted (except for this clause) to the country of residence. In cases where a country applies the saving clause to tax its residents or citizens, a credit generally is allowed for taxes paid to the other country pursuant to the article providing relief from double taxation (Article 24).

Under Code Section 877, a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes is, with respect to certain income, subject to U.S. tax for a period of 10 years following the loss of citizenship. The proposed treaty (as amended by the first provision of the proposed protocol) contains the standard provision found in the U.S. model and most recent treaties specifically retaining the right to tax former citizens. Even absent a specific provision the Internal Revenue Service has taken the position that the United States retains the right to tax former citizens resident in the other treaty country (Rev. Rul. 79-152, 1979-1 C.B. 237). The proposed protocol provides that the competent authorities of the two countries are to consult as to whether a principal purpose of a person's loss of citizenship was the avoidance of U.S. tax.

The proposed treaty provides exceptions to the saving clause for certain benefits conferred by the articles dealing with associated enterprises (Article 9), child support (Article 20); relief from double taxation (Article 24); non-discrimination (Article 25); and mutual agreement procedures (Article 26). These exceptions are consistent with those in the U.S. model.

In addition, the saving clause does not apply to the benefits conferred by one of the countries under the articles dealing with government service (Article 21), students and trainees (Article 22), and diplomatic agents and consular officers (Article 28), to individuals who are not citizens of the conferring country and do not have "immigrant status" in the conferring country. This exclusion is standard, and is included in the U.S. model. For U.S. purposes, an individual has immigrant status in the United States if he has been admitted to the United States as a permanent resident under U.S. immigration laws (i.e., holds a "green card").

Article 2. Taxes Covered

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Internal Revenue Code, but excluding the personal holding company tax (except where all of the stock of a Spanish company is owned in their capacity as individuals by individuals who are not residents or citizens of the United States (provision 2(a) of the proposed protocol)), the accumulated earnings tax (except with respect to publicly traded Spanish companies that meet the requirements of paragraph 1(f) of the article on limitation on benefits (Article 17) (provision 2(b) of the proposed protocol)), and social security contributions. Additionally, the proposed treaty applies to the excise taxes with respect to private foundations and the excise tax imposed on insurance premiums paid to foreign insurers. Under the Internal Revenue Code, premiums from insuring U.S. risks which are received by a foreign insurer having no U.S. trade or business are not subject to U.S. income tax but are subject to the U.S. insurance excise tax (Code secs. 4371-4374). This insurance excise tax is covered by the proposed treaty only to the extent that the foreign insurer does not reinsure the risks in question with a person not entitled to relief from this tax under the proposed treaty or another U.S. treaty. Therefore, under the articles on business profits (Article 7) and other income (Article 23), income of a Spanish insurer from the insurance of U.S.

risks is not subject to the insurance excise tax (except in situations where the risk is reinsured with a company not entitled to the exemption) if that insurance income is not attributable to a U.S. permanent establishment maintained by the Spanish insurer. Some other recent U.S. tax treaties cover this tax as well. In addition, the excise tax on premiums paid to foreign insurers is a covered tax under the U.S. model treaty.

The insurance excise tax will continue to apply notwithstanding the waiver provision of the proposed treaty in situations where a Spanish insurer with no U.S. trade or business reinsures a policy it has written on a U.S. risk with a foreign insurer other than a resident of Spain or another insurer entitled to exemption under a different tax treaty (such as the U.S.-French treaty). For example, a Spanish company not engaged in a U.S. trade or business insures a U.S. casualty risk and receives a premium of $200. The company reinsures part of the risk with an insurance company (not currently entitled to exemption from the excise tax) and pays that company a premium of $100. The four-percent excise tax on casualty insurance applies to the premium paid to the Spanish insurance company to the extent of the $100 reinsurance premium. Thus, the U.S. insured is liable for an excise tax of $4, which is four percent of the portion of its premium to the Spanish insurer which was used by the Spanish insurer to reinsure the risk. It is the responsibility of the U.S. insured to determine to what, if any, extent the risk is to be reinsured with a nonexempt person.

In the case of Spain, the proposed treaty applies to the income tax on individuals (el impuesto sobre la renta de las personas fisicas) and the corporation tax (el impuesto sobre sociedades). The corporation tax includes the tax imposed by Spain on insurance and reinsurance premiums earned in Spain by foreign persons.

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to identical or substantially similar taxes that either country may subsequently impose. The proposed treaty, like the U.S. model, obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in the tax laws of its country and of any published material concerning application of the treaty.

Article 3. General Definitions

The proposed treaty contains certain of the standard definitions found in most U.S. income tax treaties.

The term "Spain" means the Spanish State; when used geographically, it includes the territorial waters of Spain and any area beyond the territorial waters which by Spanish legislation and in accordance with international law is designated as an area in which Spain may exercise jurisdiction or sovereign rights with respect to the seabed, its subsoil, and superjacent waters and their natural resources. Therefore, income earned on the Spanish continental shelf is covered.

The "United States" means the United States of America, a term that does not include Puerto Rico, the Virgin Islands, Guam or any

other United States possession or territory.[12] The definition of the United States also includes, when the term is used in a geographical sense, the territorial waters of the United States and any area beyond the territorial waters that, in accordance with international law and the laws of the United States, is designated as an area within which the United States may exercise jurisdiction or sovereign rights with respect to the seabed, its subsoil, and superjacent waters, and their natural resources. The intent of this rule is to cover the U.S. continental shelf in conformity with the definition of continental shelf contained in section 638 of the Code.

The term "a Contracting State" or "the other Contracting State" means Spain or the United States, as the context requires.

The term "person" is defined to include an individual, a company and any other body of persons. A "company" is any body corporate or any entity which is treated as a body corporate for tax purposes. Provision 4 or the proposed protocol clarifies that the term "any other body of persons" specifically includes estates, trusts, and partnerships. Furthermore, the Treasury Department understands that this term includes any other persons, as defined under domestic law, which may be subject to tax (e.g., foundations, cooperatives, associations, and other similar groups of individuals and companies).

An "enterprise of a country" is defined as an enterprise carried on by a resident of that country. Although the treaty does not define the term "enterprise," it would have the same meaning that it has in other U.S. tax treaties; that is, the trade or business activities undertaken by an individual, partnership, company, or other entity.

The proposed treaty defines the term "nationals" to mean individuals possessing nationality of the relevant country, and legal persons, associations, or other entities deriving their status from the law in force in the United States or Spain. Under this definition, for example, a corporation organized under the law of one of the United States is a U.S. national. One result of this broad definition is a broad application of the non-discrimination rules (Article 25).

The proposed treaty defines "international traffic" as any transport by a ship or aircraft by an enterprise of one of the two countries, except where the transport is solely between places in the other country (i.e., wholly within the other country). Accordingly, with respect to a Spanish enterprise, purely domestic transport in the United States is not international traffic.

The U.S. competent authority is the Secretary of Treasury or his authorized representative. The U.S. competent authority function has been delegated to the Commissioner of the Internal Revenue Service, who has redelegated the authority to the Assistant Commissioner (International). On interpretive issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS.

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[12] Pursuant to provision 3 of the proposed protocol, Spain and the United States have agreed to initiate the negotiation of a Protocol to extend the application of the proposed treaty to Puerto Rico, taking into account the special features of the taxes applied by Puerto Rico.

The Spanish competent authority is the Minister of Economy and Finance or his authorized representative.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms not otherwise defined by the proposed treaty are to have the meaning which they have under the applicable tax laws of the country applying the proposed treaty.

Article 4. Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the proposed treaty assigning one of the countries as the country of residence where under the laws of the countries the person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on U.S. source income and on his income that is effectively connected with a U.S. trade or business. A company is a resident of the United States if it is organized in the United States. Under the standards for determining residence provided in the 1984 Act, an individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident. A permanent resident for immigration purposes (i.e., a "green card" holder) also is a U.S. resident. The standards for determining residence provided in the 1984 Act do not alone determine the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States).

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that State, is subject to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature.[13] The term "resident of a Contracting State" does not include, however, any person who is subject to tax in that country in respect only of income from sources in that country.

This provision of the proposed treaty generally is based on the fiscal domicile article of the U.S. model and OECD model tax treaties and is similar to the provisions found in other U.S. tax treaties. Consistent with most U.S. income tax treaties, a U.S. citizen is not considered a U.S. resident unless the individual has a substantial presence in the United States or would be a resident only of the United States based on his or her permanent home, center of vital interests, or habitual abode in the United States (provisions 5(a) of the proposed protocol). As a result, U.S. citizens residing overseas (in countries other than Spain) generally are not entitled to the benefits of the proposed treaty as U.S. residents. This result

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[13] It is understood by representatives of the Treasury Department that a person's status as a resident will not be denied simply because the income of that person is exempt from tax in a country. This would apply, for example, in the case of a pension fund which generally is exempt from U.S. income tax under the Code.

is contrary to U.S. treaty policy as expressed in the U.S. model, although the U.S. policy is achieved in very few treaties. In addition, provision 5(a) of the proposed protocol extends this limitation to U.S. green card holders.

Moreover, in the case of income derived or paid by a partnership, an estate, or trust, provision 5(b) of the proposed protocol provides that the term "resident of a Contracting State" applies only to the extent that the income derived by the partnership, estate, or trust is subject to tax in that country as the income of a resident, either in its hands or in the hands of its partners or beneficiaries. For example, if the share of U.S. residents in the profits of a U.S. partnership is only one-half, Spain would have to reduce its withholding tax on only half of the Spanish source income paid to the partnership.

Under provision 5(c) of the proposed protocol, the definition of the term "resident" is extended to include a Contracting State or a political subdivision or a local authority thereof.

The proposed treaty provides a set of "tie-breaker" rules to determine residence in the case of an individual who, under the basic treaty definition, is considered a resident of both countries. Such a dual resident individual is deemed a resident of the country in which he has a permanent home available to him. If this permanent home test is inconclusive because the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his personal and economic relations are closer, i.e., his "center of vital interests". If the country in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either country, he is deemed to be a resident of the country in which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he is deemed to be a resident of the country of which he is a national as defined in the article setting forth general definitions (Article 3). If he is a national of both countries or of neither of them, the competent authorities of the countries are to endeavor to settle the question of residence by mutual agreement.

In the case of a person other than an individual that is resident in both countries under the general definition, the proposed treaty requires the competent authorities of the two countries to endeavor to settle the question by mutual agreement and to determine how the proposed treaty applies to that person. If the competent authorities are unable to make a determination of residence, the person is not treated as a resident of either country except that it is treated as a resident of both countries for purposes of payments made by such person covered by the articles on dividends (Article 10), interest (Article 11), and royalties (Article 12). This means, for example, that if a dual resident company pays a dividend to a Spanish resident, the U.S. withholding tax on that dividend is limited by the proposed treaty. Conversely, if that same company paid a dividend to a resident of the United States, the Spanish withholding tax on that dividend likewise is limited by the proposed treaty.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" which, with certain exceptions, follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the reduced rates of, or certain exemptions from, tax provided for dividends, interest, and royalties will apply unless the income is attributable to the permanent establishment, in which case such items of income are taxed as business profits. U.S. taxation of business profits is discussed under Article 7 (Business Profits).

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which an enterprise engages in business in the other country. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes any building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, if the activity lasts for more than 6 months. Where activities are carried on by an enterprise that is associated with another enterprise as defined in the proposed treaty (Article 9), the two enterprises are deemed to be a single enterprise for purposes of determining whether the 6-month test has been satisfied if the activities of both enterprises are substantially the same, unless they are carried on simultaneously. The proposed treaty's 6-month period is significantly shorter than the 12-month period required in the U.S. model treaty in determining whether similar activities constitute a permanent establishment.

The general rule is modified to provide that a fixed place of business that is used solely for specified activities will not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the enterprise or for the maintenance of a stock of goods belonging to the enterprise solely for storage, display, or delivery, or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information, or solely for the purpose of carrying on, for the enterprise, any other similar activity of a preparatory or auxiliary character. In addition, these activities include the maintenance of a fixed place of business solely for any combination of the activities mentioned in this paragraph as long as the overall activity of the fixed place of business resulting from these activities is of a preparatory or auxiliary character.

If a person has, and habitually exercises, the authority to conclude contracts in a country on behalf of an enterprise of the other

country, then the enterprise generally is deemed to have a permanent establishment in the first country. This rule does not apply where the person's activities are limited to the activities specified in the previous paragraph which would not constitute a permanent establishment if carried on by the enterprise through a fixed place or business located in the first country (i.e., the purchase of goods, the collection of information, and any activity of a preparatory or auxiliary nature). The proposed treaty contains the usual provision that the agency rule will not apply to create a permanent establishment if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business.

The determination whether a company of one country has a permanent establishment in the other country is made without regard to the fact that the company is related to a company that is a resident of the other country or to a company that engages in business in that other country. The relationship is thus not relevant; only the activities of the company being tested are relevant.

Article 6. Income from Real Property (Immovable Property)

This article covers income derived from the ownership of real (immovable) property. The rules governing income from the sale of real property are set forth in Article 13.

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country is taxable in the country where the real property is located. Income from real property includes income from agriculture or forestry.

The term "real property" has the meaning which it has under the law of the country in which the property in question is situated. The term in any case includes property accessory to real property, livestock and equipment used in agriculture and forestry, the right to which the provisions of general law respecting landed property apply, usufruct of real property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Thus, income from real property will include royalties and other payments in respect of the exploitation of natural resources (e.g., oil). Ships, aircraft and containers used in international traffic are not real property.

The source country may tax income derived from the direct use, letting, or use in any other form of real property. These rules allowing source-country taxation also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

Where ownership or participation rights in a company or other entity include a right to enjoy real property situated in one of the countries, the income, whether actual or imputed, from that property right is taxable in that country. It is understood that this provision was added to the proposed treaty to permit Spain to tax imputed rental income in certain cases where real property held by a company or other entity is made available to the owner of shares or other rights in such company or entity. This rule might apply, for example, where a U.S. corporation owns a Spanish resort property and grants to its shareholders time-share rights to that prop-

erty. In such a case, Spain may tax the imputed rental income attributable to that property either to the company or to the shareholders in accordance with its domestic law.

Certain U.S. treaties and the current U.S. model treaty permit residents of one country to elect to be taxed on income from real property in the other country on a net basis. The proposed treaty does not contain an election, but such an election is provided for U.S. real property income under the Code (secs. 871(d) and 882(d)), and Spain taxes income from real property on a net basis if such property is attributable to a permanent establishment or fixed base and such income is part of the business income of the permanent establishment or fixed base. In cases where a permanent establishment or fixed base does not exist in Spain, the passive income arising from the property generally is subject to a 25-percent gross-basis tax, collected through withholding. Certain treaties limit the tax a country may impose on rental income from real property. There is no such limit in the proposed treaty.

Under the article on capital gains (Article 13), gains from the alienation of real property are also taxable by the country where the property is located. In addition, gains from the alienation of shares of certain corporations owning real property situated in a treaty country (e.g., stock in U.S. real property holding companies) are taxable in that country.

Article 7. Business Profits

U.S. Code rules

U.S. law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate tax rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected income.

In the case of foreign persons other than insurance companies, foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. For such persons, only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends or inter-

est either derived in the active conduct of a banking, financing or similar business in the United States, or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office.

The foreign source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code may be treated as U.S.-effectively connected without regard to the foregoing rules, so long as such income is attributable to its United States business. In addition, the net investment income of such a company which must be treated as effectively connected with the conduct of an insurance business within the United States is not less than an amount based on a combination of asset/liability ratios and rates of return on investments experienced by the foreign person in its world-wide operations and by the U.S. insurance industry.

Except in the case of a dealer, trading in stocks, securities or commodities in the United States for one's own account does not constitute a trade or business in the United States and accordingly income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S. based employee, a resident broker, commission agent, custodian or other agent or trading by a foreign person physically present in the United States.

The Code, as amended by the 1986 Act provides that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year. In addition, the Code provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business.

Proposed treaty rules

Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in trade or business before a country can tax business profits and by substituting the "attributable to" standard for the Code's "effectively connected" standard. Under the Code, on the one hand, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be

present and the business profits must be attributable to that fixed place of business.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to a permanent establishment the business profits which might be expected to have been derived by it if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment, or with any other associated enterprise. For example, this arm's-length rule applies to transactions between the permanent establishment and a branch of the resident enterprise located in a third country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions are allowed for expenses, wherever incurred, which are attributable to the activities of the permanent establishment. These deductions specifically include research and development expenses, interest, and executive and general administrative expenses. Thus, for example, a U.S. company which has a branch office in Spain but which has its head office in the United States is, in computing the Spanish tax liability of the branch, entitled to deduct the executive and general administrative expenses incurred in the United States by the head office that are reasonably connected with the profits of the Spanish branch.

Unlike some U.S. treaties and the U.S. model, the proposed treaty does not define the term "business profits." Thus, to the extent not dealt with in other Articles, the term is defined under the laws of the two countries. If the definitions cause double taxation, the competent authorities could agree on a common meaning of the term. The proposed treaty may thus leave it to Spanish law, for example, to determine whether an item of income not dealt with elsewhere in the treaty that is earned by a U.S. company through a permanent establishment in Spain constitutes business profits and, therefore, is taxable by Spain under this treaty article.

Business profits are not attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for the account of the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities are not increased by a profit element in its purchasing activities.

The amount of profits attributable to a permanent establishment shall include only the profits or losses derived from the assets or activities of the permanent establishment, and must be determined by the same method each year unless there is good and sufficient reason to change the method.

Where business profits include items of income which are dealt with separately in other articles of the proposed treaty, those other articles, and not the Business Profits Article, will govern the treatment of those items of income. Thus, for example, film rentals are taxed under the provisions of Article 12 (Royalties), and not as business profits, except as provided in paragraph 4 of Article 12.

Article 8. Shipping and Air Transport

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries providing such reciprocal exemptions.

The proposed treaty provides that profits which are derived by an enterprise of one country from the operation of ships or aircraft in international traffic ("shipping profits") are exempt from tax by the other country, regardless of the existence of a permanent establishment in the other country. International traffic means any transportation by ship or aircraft, except where the transportation is solely between places in the other country (Article 3(1)(h) (General Definitions)). The exemption also applies to income derived from the operation of ships and aircraft in international traffic through participation in a pool, a joint business, or an international operating agency.

This article on shipping and air transport is subject to the provisions of the saving clause (paragraph 3 of Article 1). Thus, the United States generally may tax the income from the operation of ships or aircraft in international traffic derived by its citizens and residents, notwithstanding the provisions of this article.

Pursuant to provision 6 of the proposed protocol, the term "income from the operation of ships or aircraft in international traffic" is defined in accordance with paragraphs 5 through 12 of the Commentary on Article 8 (Shipping, Inland Waterways Transport, and Air Transport) of the OECD model treaty. Thus, for example, profits obtained from the leasing of a fully equipped ship or aircraft are treated as profits from the operation of such a ship or aircraft in international traffic. On the other hand, Article 8 does not apply to profits generated from the leasing of ships or aircraft on a bareboat charter basis, except when such leasing provides an occasional source of income to an enterprise engaged in the international operation of ships or aircraft (paragraph 5 of the Commentary on Article 8 of the OECD model).

Profits generated from activities auxiliary to shipping and air transport enterprises are also subject to the provisions of Article 8 of the proposed treaty. Such auxiliary activities may include, for example, the sale of passage tickets on behalf of other enterprises, the operation of a bus service connecting a town with its airport, advertising and commercial propaganda, and transportation of goods by truck connecting a depot with a port or airport (paragraphs 7 and 8 of the Commentary on Article 8 of the OECD model). In addition, if an enterprise engaged in international transport undertakes to see to it that, in connection with such transport, goods are delivered directly to the consignee in the other country (either by the enterprise or with the use of an unrelated carrier), the profits attributable to transport between places in the other country are considered profits from the operation of ships or aircraft in international traffic (paragraph 9 of the Commentary on

Article 8 of the OECD model). The reason for this result is that the profits are not solely attributable to transport between two places in the other country, but rather are in connection with or incidental to international transport.

Profits derived by an enterprise engaged in international transport from the use, maintenance, or lease of containers, and related equipment for the transport of containers, which are supplementary or incidental to its international operation of ships or aircraft fall within the scope of Article 8 (paragraph 10 of the Commentary on Article 8 of the OECD model). Provision 9 or the proposed protocol limits taxation of such income to the country in which the recipient is a resident.

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision similar to Code section 482. Under this provision of the proposed treaty, each country may make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements which would have been made between independent enterprises. It is understood that this provision does not limit the United States' right to apply Code section 482 to residents of either treaty country or to the residents of third countries. Thus, the absence from this article of paragraph 3 of the corresponding article of the U.S. model does not imply that the rule embodied in the latter is in any way inconsistent with, or different from, the rule embodied in Article 9 of the proposed treaty.

For purposes of the proposed treaty an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control or capital of the other enterprise. The enterprises are also related if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

When a redetermination of tax liability has been made by one country, the other country shall make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In determining this adjustment, due regard is to be given to the other provisions of the proposed treaty and protocol and, if necessary, the competent authorities of the two countries shall consult with one another. To avoid double taxation, the proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship will not apply in the case of such adjustments.

Article 10. Dividends

The United States generally imposes a 30-percent tax on the gross amount of U.S. source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax like a U.S. person at the standard graduated rates on a net basis.

U.S. source dividends for purposes of the 30-percent tax are dividends paid by a U.S. corporation (other than a corporation which has in effect an election under Code sec. 936). Also treated as U.S. source dividends for this purpose are certain dividends paid by a foreign corporation if at least 25 percent of the gross income of the foreign corporation, in the prior three year period, was effectively connected with a U.S. trade or business of that foreign corporation.

Under the proposed treaty, dividends paid by a company that is a resident of one country to a resident of the other country are taxable by both countries. The proposed treaty limits, however, the rate of tax that the country of which the payor is a resident may impose on dividends paid to a beneficial owner in the other country. (None of the limitations on taxation of dividends apply to taxation of the company in respect of the profits out of which the dividends are paid.) The limitation is 15 percent or 10 percent, depending on the relationship between the payor and the payee. With one exception discussed below, the rate of source-country tax can never exceed 15 percent of the gross amount of the dividends. The 10-percent rate of source-country tax applies to dividends if the beneficial owner is a company which owns at least 25 percent of the voting stock of the company paying the dividends. The 15-percent rate applies to dividends in all other cases.

The proposed treaty defines dividends to mean income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subject to the same tax treatment as income from shares by the laws of the country of which the company making the distribution is a resident. The term dividends, under the proposed treaty, also includes income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the domestic law of the country in which the income arises. This definition of dividend allows the United States to apply its domestic rules for determining whether an interest is debt or equity. Moreover, provision 7(a) of the proposed protocol provides the understanding that the term dividends includes profits on a liquidation of a company which is resident of one of the countries.

The reduced rates of tax on dividends apply unless the beneficial owner of the dividends carries on or has carried on business through a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and the dividends are attributable to the permanent establishment (or fixed base). Dividends attributable to a permanent establishment are taxed on a net basis as business profits (Article 7). Dividends attributable to a fixed base are taxed on a net basis as income from the performance of independent personal services (Article 15).

One country may tax dividends paid by a company not resident in that country, only in two cases: first, where its own resident receives the dividends; and second, where the dividends are attributable to a permanent establishment or a fixed base in that country.

Provisions 7(b) through (d) of the proposed protocol permit imposition of the 15-percent tax rate on certain dividends paid to companies regardless of their level of ownership, and permit full operation of internal law on dividends paid to certain investors by U.S.

real estate investment trusts (REITs). First, income, whether distributed to them or not, attributable to shareholders of the Spanish corporations and entities referred to in Article 12.2 of Law 44/1978 of September 8, 1978 and Article 19 of Law 61/1978 of December 27, 1978 or successor statutes, as long as such income is exempt from Spanish corporation tax. It is understood that the entities specified above are similar to REITs and regulated investment companies (RICs) in the United States in that only a shareholder level tax is collected on income earned by such entities. Second, 15-percent tax is permitted to be imposed on all dividends paid by a Spanish investments institution which is subject to tax in Spain according to Article 34 or 35 of Law 46 of December 26, 1984 or successor statutes. Third, 15-percent tax is permitted to be imposed on all dividends paid by a U.S. RIC or REIT. In the case of a REIT, if the beneficial owner of the dividends is an investor (other than an individual) holding at least a 25-percent interest in the REIT, the rate of withholding applicable under domestic law (currently 30 percent) may be applied, rather than any reduced rate prescribed by the treaty.

The article on dividends is subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States may tax its citizens and residents on dividend income without regard to the provisions contained in the proposed treaty. Specifically, in the case of dividends paid by a U.S. company to a U.S. citizen resident in Spain, the U.S. tax is not limited by the source country withholding limits contained in Article 10.

Article 11. Interest

Subject to numerous exceptions, the United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that apply to dividends. Interest paid, however, on certain portfolio indebtedness to nonresident alien individuals and foreign corporations, and interest on deposits in banks is exempt from U.S. tax. U.S. source interest, for this purpose, generally is interest on debt obligations of a U.S. person, other than a U.S. person that meets the foreign business requirements of Code section 861(c) (e.g., an "80/20" company). Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is also subject to a branch-level interest tax, which is the tax it would have paid had a wholly owned domestic corporation paid it the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

Under the proposed treaty, interest is taxable by a country if the beneficial owner of the interest is a resident of that country, the interest arose in that country, or the interest is attributable to a permanent establishment or fixed base in that country. The proposed treaty generally limits the withholding tax imposed at source on interest paid to a beneficial owner who is a resident of the other country to 10 percent. The U.S. model treaty provides for elimination of the withholding tax on interest (i.e., a zero rate), although this result is rarely achieved.

The reduced rate established by the proposed treaty applies only if the interest is beneficially owned by a resident of the other coun-

try. Accordingly, it does not apply if the recipient is a nominee for a nonresident. Article 17 of the proposed treaty provides additional rules designed to prevent treaty shopping.

The reduced tax rate will not apply if the recipient carries on or has carried on business through a permanent establishment or performs or has performed services from a fixed base in the source country and the interest is attributable to that permanent establishment or fixed base. In that event, the interest is taxed as business profits (Article 7) or income from the performance of independent personal services (Article 15).

The proposed treaty defines interest to mean income from debt-claims of every kind, whether or not secured by mortgage and, subject to the definition of the term "dividends" provided the article on dividends (Article 10, paragraph 3), whether or not carrying a right to participate in the debtor's profits, and all income treated as interest by the tax law of the source country. Thus, the United States could apply its domestic rules for determining whether an interest is debt or equity. The proposed treaty specifies that income from government securities, and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds or debentures constitute interest. Conversely, penalty charges for late payment are not treated as interest under the proposed treaty.

Certain exceptions apply to the general rule that permits the source country to tax interest. Interest is exempt from tax by the source country under the proposed treaty if the interest is beneficially owned by the other country, its political subdivision or local authority, if agreed upon by the competent authorities of the two countries, any instrumentality of that other country. Also, interest on loans with maturities of five or more years granted by banks or other financial institutions which are residents of one of the countries is subject to tax only in that country. Interest paid in connection with the sale on credit of any industrial, commercial, or scientific equipment is taxable under the proposed treaty only in the country in which the beneficial owner of the interest is a resident. Finally, provision 8 of the proposed protocol sets forth the understanding that income derived from financial assets covered by Spanish Law 14 of May 25, 1985 or successor statutes is considered interest for purposes of the proposed treaty. However, when that income is subject to a special withholding tax at the time of issue of the financial asset, the limitation on the rate of source-country tax does not apply. The Treasury Department understands that Law 14 permits Spain to impose a 55-percent withholding tax on the equivalent of original issue discount at the time of issue of certain bearer bonds, in lieu of taxing bond payments as they mature.

The proposed treaty provides a source rule for interest (which is not relevant to Article 24 (Relief from Double Taxation) for foreign tax credit purposes). Interest is sourced within a country if the payor is the government of that country, including political subdivisions and local authorities, or a resident of that country. If, however, the interest expense is borne by (i.e., for purposes of computing taxable income, deductible by) a permanent establishment (or fixed base) that the payor has in Spain or the United States and the indebtedness was incurred with respect to that permanent establishment (or fixed base), interest has its source in that country,

regardless of the residence of the payor. Generally, this is consistent with U.S. source rules (secs. 861-862) which provide as a general rule that interest income is sourced in the country in which the payor is resident. Thus, for example, if a Swiss resident has a permanent establishment in Spain and that Swiss resident incurs indebtedness to a U.S. person for that Spanish permanent establishment, and the permanent establishment bears the interest, then the interest will have its source in Spain.

The proposed treaty addresses the issue of interest charges not at arm's length between parties having a direct or indirect special relationship by providing that the amount of interest for purposes of the treaty is the amount of arm's-length interest. The amount of interest in excess of the arm's-length interest is taxable according to the laws of each country, taking into account the other provisions of this treaty (e.g., excess interest paid to a shareholder may be treated as a dividend under local law and thus entitled to the benefits of Article 10 of the proposed treaty).

The article on interest is subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States may tax its citizens and residents on interest income without regard to the provisions contained in the proposed treaty.

Article 12. Royalties

Under the same system that applies to dividends and some interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangibles in the United States. Such royalties include motion picture royalties.

The U.S. model treaty exempts royalties from tax at source. The proposed treaty, conversely, allows limited source-basis taxation of royalties. Generally, royalties from sources (under the royalty source rule discussed below) in one country that are beneficially owned by a resident of the other country are taxable by both countries. As an exception to this general rule, provision 9(a) of the proposed protocol provides that royalties received in consideration for the use of, or for the right to use, containers (and related equipment) in international traffic, are taxable only by the country in which the recipient is a resident.

The source-country tax rate limitation is 5 percent, 8 percent, or 10 percent, depending on the type of property whose use the royalty allows. If a payment of any kind is received as consideration for the use of (or the right to use) any copyright of literary, dramatic, musical, or artistic work, the source-country tax rate cannot exceed 5 percent of the gross amount of the royalty. If a royalty payment is received in consideration for the use of (or the right to use) cinematographic films, or films, tapes, or other means of transmission or reproduction of image or sound, the source-country tax rate cannot exceed 8 percent of the gross amount of the royalty. The 8-percent rate also applies with respect to royalties received for the use of, or the right to use, industrial, commercial, or scientific equipment (except for containers used in international traffic as discussed above), or for any copyright of scientific work. (For pur-

poses of this provision, paragraph 9(b) of the proposed protocol states that the determination of whether a payment is in consideration for a copyright for a scientific work is based on the applicable domestic law of the country in which the royalty arises). In all other cases of royalty payments, the source-country tax rate cannot exceed 10 percent of the gross amount of the royalties. Royalties received as consideration for technical assistance are taxable under the proposed treaty at the rate applying to the royalties stipulated in respect of the rights or property to which the technical assistance is related. That is, the proposed treaty does not attempt to distinguish between payments made for, or the withholding rate on, a patented process, and those made for a technician, supplied by the patent holder, to monitor that process. For this specific purpose, the taxable base is computed net of labor and material costs in producing such royalties.

The rate limitations in the proposed treaty apply only if the royalty is beneficially owned by a resident of the other country; they do not apply if the recipient is a nominee for a nonresident.

Royalties are defined to mean payments of any kind received in consideration for the use of, or the right to use, any copyright of literary, dramatic, musical, artistic or scientific work, including cinematographic films or films, tapes or other means of image or sound reproduction, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience. The definition of the term "royalties" also includes both payments for technical assistance performed in one of the countries by a resident of the other country where such assistance is related to the application of any such right or property, and gains derived from the alienation of such right or property to the extent that such gains are contingent on the productivity, use, or disposition thereof. Similar gains that are not so contingent are subject to the rules of the article on capital gains (Article 13).

The reduced withholding tax rate does not apply where the beneficial owner carries on or has carried on business through a permanent establishment in the source country or performs or has performed personal services in an independent capacity from a fixed base in the source country, and the royalties are attributable to the permanent establishment or fixed base. In that event, the royalties are taxed as business profits (Article 7) or income from the performance of independent personal services (Article 15).

The proposed treaty provides special source rules for royalties. Generally under U.S. tax rules (secs. 861-862), royalty income is sourced where the property or right is being used. Under Spanish rules, royalties generally are sourced according to the residence of the payor. The proposed treaty provides a compromise between these two sourcing rules. As a general rule under the proposed treaty, if the payor of a royalty is the government of one of the countries (or a political subdivision or local authority thereof), the royalty is sourced in that country. If the payor of a royalty (whether or not a resident of one of the countries) has a permanent establishment or fixed base in the United States or Spain in connection with which the liability to pay the royalty was incurred, and if the

royalties are borne by the permanent establishment or fixed base, the royalties arise (for purposes of the proposed treaty) in the country in which the permanent establishment or fixed base is situated. In cases where the royalty is not borne by a permanent establishment or fixed base located in one of the countries, the royalty is sourced in the payor's country of residence. Finally, in situations where the payor of a royalty is not a resident of either country and the royalty is not borne by a permanent establishment or a fixed base located in either country, but the royalty relates to the use of, or the right to use, in one of the countries, property described in the proposed treaty's definition of the term "royalty," the royalty is sourced in that country of use.

The proposed treaty's source rules for royalties detailed above are applicable only for purposes of determining whether royalties are taxable in the country of source under Article 12. These rules do not apply with respect to the determination of source for purposes of the permitting a foreign tax credit under the article for relief from double taxation (Article 24).

The proposed treaty provides that in the case of royalty payments or credits between persons having a special relationship, only that portion of the payment or credit that represents an arm's-length royalty is treated as a royalty under the treaty. Payments in excess of the arm's-length amount are taxable according to the law of each country with due regard being given for the other provisions of the proposed treaty. Thus, for example, an excess amount might be treated as a dividend subject to the taxing limitations of Article 10.

The article on royalties is subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States may tax its citizens and residents on royalty income without regard to the provisions contained in the proposed treaty. Specifically, in the case of a royalty from a U.S. company accruing to a beneficial owner who is a U.S. citizen resident in Spain, the U.S. tax is not limited by the source country withholding limits contained in Article 12.

Article 13. Capital Gains

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he is physically present in the United States for at least 183 days during the taxable year. Under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), as amended, however, a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain U.S. corporations holding U.S. real property.

Under the proposed treaty, only certain capital gains are taxable in the source country. Gains from the disposition of real property are taxable in the country where the real property is situated. The term "real property" is defined in the article on income from real property (Article 6). In addition, provision 10(a) of the proposed pro-

tocol provides that for purposes of the article on capital gains, real property in the United States includes a United States real property interest. Currently the term is defined in Code section 897(c). This definition allows the United States to tax any transaction of a Spanish resident taxable under FIRPTA. By virtue of the article on non-discrimination and Code section 897(i), a company resident in Spain holding a U.S. real property interest is permitted to elect to be treated as a U.S. corporation with respect to U.S. taxation of that interest.

In order to grant taxing rights to Spain equivalent to those provided to the United States under the above rules, the proposed treaty provides for taxation in Spain of gains from the alienation of stock, participations, or other rights in a company or other legal person the property of which consists, directly or indirectly, mainly of real property situated in Spain (i.e., its real property assets are greater than its movable property assets).

Gains from the alienation of personal property which are attributable to a permanent establishment which an enterprise of a country has or had in the other country, or which are attributable to a fixed base which is or was available to a resident of a country in the other country for the purpose of performing independent personal services, and gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or such a fixed base, are taxable in that other country.

Provision 10(b) of the proposed protocol provides that gains from the alienation of personal property which are attributable to a permanent establishment which an enterprise of one country has or had in the other country, which property is removed from the other country, are taxable in that other country in accordance with its domestic law, but only to the extent of the gain that has accrued as of the time of such removal. Such property is also taxable under the proposed protocol by the first country in accordance with its domestic law, but only to the extent of the gain accruing subsequent to the time of such removal. Currently under Spanish law, a tax is levied on the accrued, but unrealized, gain in such cases at the time of removal. Under U.S. law, Code section 864(c)(7) permits taxation of certain gain realized on property previously removed from a U.S. trade or business.

In addition to the rules discussed above, if a resident of one of the countries derives gain from the alienation of stock, participations, or other rights in the capital of a company or other legal person that is a resident of the other country and during the previous 12-month period had, directly or indirectly, a participation of at least 25 percent of the capital of that company or other legal person, such gain is taxable in that other country. This rule represents a significant departure from the U.S. model and the OECD model treaties. Under this rule, for example, Spain is permitted to tax the gain arising from the disposition by a U.S. person of stock in a Spanish company, if that U.S. person owned at least 25 percent of the capital of that company. Under current U.S. law, the United States would not levy a tax on the gain derived by a Spanish person in the reciprocal situation (except in the case of a disposition of stock in a U.S. real property holding corporation). Howev-

er, legislation has been introduced which would permit the United States to tax similar gains.[14]

Under the rules of the proposed treaty which permit a country to tax gains from dispositions of domestic stock by substantial shareholders, it is specified that where necessary to avoid double taxation of such a gain, the gain is deemed to arise in that country. Thus, the gain of a U.S. person from the disposition of stock in a Spanish company which is subject to Spanish tax is considered foreign source income under this rule for purposes of determining that person's U.S. foreign tax credit.

Provision 10(c) of the proposed protocol states that for purposes of the above rule, an alienation does not include certain transfers of stock between various members of a controlled group of companies that file a tax return on a consolidated basis. This exception applies to the extent that the consideration received by the transferor consists of participations or other rights in the capital of the transferee or of another company resident in the same country that owns (directly or indirectly) 80 percent or more of the voting rights and value of the transferee, if the following three conditions are met. First, the transferor and transferee must be resident in the same country (either the United States or Spain). Second, the transferor or transferee must own (directly or indirectly) 80 percent or more of the voting rights and value of the other, or a company resident in the same country owns (directly or indirectly through companies resident in the same country) 80 percent or more of the voting rights and value of each of them. Third, for the purpose of determining gain on any subsequent disposition, a carryover basis must be used, increased by any cash or other property paid. If cash or other property is received, the amount of the gain, limited to the amount of such cash or other property received, is taxable by the other country.

Gains from the sale or exchange of ships, aircraft or containers operated or used by an enterprise of one country in international traffic are taxable only by the country of the enterprise's residence. The ships, aircraft, and containers whose disposition is exempt from source country capital gains tax under this provision corresponds to the property the profits from which are exempt from source-country tax under the article on shipping and air transport (Article 8).

Income or gains from the alienation of any property other than property discussed above are taxable under the proposed treaty only in the country where the alienator is a resident.

The article on gains is subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States may tax its citizens and residents on gains without regard to the provisions contained in the proposed treaty. For example, in the case of a gain from the alienation of ships, aircraft, or containers, recognized by a U.S. citizen resident in Spain, the United States is not limited in its ability to tax such gain by the provisions contained in Article 13.

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[14] H.R. 4308 (sec. 201, 101st Cong., 2d Sess. (1990)) and S. 2410 (sec. 201, 101st Cong., 2d Sess. (1990)).

Article 14. Branch Tax

U.S. Code rules

The 1986 Act imposed branch level taxes on foreign corporations earning income effectively connected with the conduct of a U.S. trade or business. The branch profits tax is imposed at a rate of 30 percent on a foreign corporation's dividend equivalent amount. Under the branch tax provisions, no U.S. treaty shall exempt any foreign corporation from the branch profits tax (or reduce the amount thereof) unless the treaty is an income tax treaty and the foreign corporation is a "qualified resident" of the treaty country.

A "qualified resident" is defined as any foreign corporation which is a resident of a treaty country if it can meet at least one of the following tests. First, any foreign corporation resident in a treaty country is a qualified resident of that country unless 50 percent or more (by value) of the stock of the corporation is owned (directly or indirectly within the meaning of Code section 883(c)(4)) by individuals who are not residents of the treaty country and who are not U.S. citizens or resident aliens, or 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of the treaty country or the United States (a "base erosion" rule). Second, a foreign corporation resident in a treaty country is a qualified resident if the stock of the corporation is primarily and regularly traded on an established securities market in the treaty country, or if the corporation is wholly owned (directly or indirectly) either by another foreign corporation which is organized in the treaty country and the stock of which is so traded or by a domestic corporation whose stock is primarily and regularly traded on an established securities market in the United States. Third, the corporation may receive qualified resident status if it establishes to the satisfaction of the Secretary that it meets such requirements as the Secretary may establish to ensure that individuals who are not residents of the treaty country do not use the treaty in a manner inconsistent with the purposes of the rules contained in the Code provisions regarding the branch profits tax.

The 1986 Act also imposed a 30-percent tax on any interest paid or deducted by the U.S. trade or business of a foreign corporation to a foreign person. This tax may be reduced or eliminated by treaty in cases where either the foreign corporation or the recipient of the interest is a qualified resident of a treaty country. The rules for determining whether a person is a qualified resident for this purpose are the same as discussed above for the branch profits tax.

Proposed treaty rules

The proposed treaty explicitly permits the United States to impose a branch profits tax on a company which is resident in Spain. The maximum rate of this tax, however, cannot exceed 10 percent of the dividend equivalent amount of the business profits of the company which are effectively connected (or treated as such) with the conduct of a U.S. trade or business and are either attributable to a permanent establishment in the United States or subject to tax in the United States under the article on income from real property (Article 6) or gains from the disposition of real prop-

erty situated in the United States (Article 13, paragraph 1). With respect to income from U.S. real property, provision 11(a) of the proposed protocol clarifies that the branch profits tax may be imposed only if that income has been subject to U.S. tax on a net basis.

The proposed treaty also permits the United States to levy a branch-level tax on the excess, if any, of interest deductible in computing the profits of the corporation which are either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 or paragraph 1 of Article 13 of the proposed treaty over the interest paid by or from that permanent establishment or trade or business in the United States. As with the branch profits tax, the maximum rate of tax at which the branch interest tax may be imposed under the proposed treaty is 10 percent. In the case of a bank (including a savings bank ("Cajas de Ahorro"), pursuant to provision 11(b) of the proposed protocol) which is a resident of Spain, this maximum rate is reduced to 5 percent.

The proposed treaty contains a reciprocal rule which permits Spain to levy a branch profits tax of no more than 10 percent on the earnings of a U.S. corporation attributable to a permanent establishment in Spain or from income or gains from real property located in Spain, as well as a 10-percent branch-level interest tax (reduced to 5 percent for U.S. banks) on the excess interest expense of a U.S. corporation allocable to its permanent establishment in Spain. Although Spain has statutory provisions for imposition of a branch tax, it is understood that such provisions are not currently in force.

Article 15. Independent Personal Services

The United States taxes the income of a nonresident alien individual at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7 (Business Profits).) The performance of personal services within the United States can be a trade or business within the United States (sec. 864(b)).

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services is treated separately from income from the performance of personal services as an employee.

Income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) in one country (the "source country") by a resident of the other country is exempt from tax in the source country, unless the individual has or had a fixed base regularly available to him in that country for the purpose of performing the services. In such case, the source country can tax only that portion of the individual's income that is attributable to the fixed base.

Independent personal services include especially independent scientific, literary, artistic, educational, and teaching activities, as

well as independent services of physicians, lawyers, engineers, architects, dentists, and accountants.

According to provision 12 of the proposed protocol, the term "fixed base" is interpreted in accordance with the Commentary on Article 14 (Independent Personal Services) of the OECD model treaty, and with any guidelines which, for the application of such Article, are developed in the future. The Commentary clarifies that independent personal services attributable to a fixed base are taxed on a net basis under principles analogous to those applicable to the taxation of business profits under Article 7 of the proposed treaty. In addition, the Commentary states that although it had not been thought appropriate to attempt to define the term "fixed base" in the treaty itself, it would cover, for instance a physician's consulting room or the office of an architect or lawyer (paragraph 4 of the Commentary on Article 14 of the OECD model).

The article on independent personal services is subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States may tax its citizens and residents on income derived from the performance of independent personal services without regard to the provisions contained in the proposed treaty. For example, in the case of such income earned by a U.S. citizen resident in Spain, the U.S. tax is not limited by the rules contained in Article 15.

Article 16. Dependent Personal Services

Under the Code, the income of a nonresident alien individual from the performance of personal services in the United States is not taxed if the individual is present in the United States for less than 90 days during a taxable year, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign permanent establishment of a U.S. person.

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country is taxable only in the country of residence if three requirements are met: (1) the individual is present in the source country for fewer than 184 days during any 12-month period; (2) his or her employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or fixed base of the employer in the source country.

Compensation derived by an employee in respect of employment as a member of the regular complement (i.e., a member of the permanent crew) of a ship or aircraft operated in international traffic by an enterprise of one of the countries is taxable by the country of that enterprise. Under the U.S. model treaty, by contrast, only the country where the employee resides may tax the income.

This article is modified in some respects for pensions (Article 20) and compensation derived as a government employee (Article 21).

The article on dependent personal services is subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States may tax its citizens and residents on employment income without regard to the provisions contained in the proposed treaty. For example, in the case of such income

earned by a U.S. citizen resident in Spain, the U.S. tax is not limited by the rules contained in Article 16.

Article 17. Limitation on Benefits

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Spain as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. Such use is known as "treaty shopping," and refers to the situation where a person who is not a resident of either country seeks to obtain certain benefits under the income tax treaty between the two countries. In certain circumstances, and without appropriate safeguards, the nonresident may be able to secure these benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third country resident to repatriate funds to that third country from the entity under favorable conditions (i.e., it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed treaty contains provisions intended to limit the use of the treaty to bona fide residents of the two countries. This is accomplished by providing that a person who is a resident of one country and derives income from the other country is entitled to relief under the proposed treaty from taxation in the other country only if it satisfies any one of the following seven safe harbor tests.

First, status as an individual constitutes a safe harbor. Second, no limitation of benefits will apply to the governments (including political subdivisions and local authorities) of the two countries. Third, non-profit religious, charitable, scientific, literary, educational private organizations, and comparable public institutions resident in a treaty country will receive treaty benefits. Fourth, similar treatment is provided to tax-exempt organizations (other than those detailed in the previous sentence), if more than half of the beneficiaries, members, or participants, if any, in such an organization are entitled to benefits under the treaty.[15]

Fifth, if the income derived in the other country is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the country of residence (other than the business of making or managing investments by a person other than a bank or insurance company), then no limitation on treaty benefits shall apply. Under this test, the income does not have to be attributable to a permanent establishment in the country in which the income arises. Rather, it only has to be derived by

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[15] Pursuant to provision 13 of the proposed protocol, the tax-exempt organizations described under the fourth safe harbor test include, but are not limited to, pension funds, pension trusts, private foundations, trade unions, trade associations, and similar organizations. In all cases, a pension fund, pension trust, or similar entity organized for the purposes of providing retirement, disability, or other employment benefits that is organized under the laws of either the United States or Spain is entitled to treaty benefits if the organization which sponsors such fund, trust, or entity is not limited with respect to treaty benefits under this article of the proposed treaty.

a resident of one of the countries in connection with, or incidental to, the active conduct of a trade or business in that country.

The sixth test is a public company test. Under this test, a company that has substantial and regular trading in its principal class of stock on a recognized securities exchange (a term defined below) is entitled to the benefits of the treaty regardless of where its actual owners reside. In addition, the public company test is satisfied where more than 50 percent of each class of stock of a company is owned by a resident of the same country in whose principal class of shares there is substantial and regular trading on a recognized securities exchange. The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc. in the United States; any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; the Spanish stock exchange; and any other stock exchange agreed upon by the competent authorities of the two countries.

The seventh test is based on the ownership of the entity and the absence of "base erosion." Under the ownership test, more than 50 percent of the beneficial interest (in the case of a company, more than 50 percent of the number of shares of each class of shares) in that entity must be owned directly or indirectly by any combination of one or more persons that meet any of the other limitation on benefits tests (other than the active business test) or who are citizens of the United States. In addition, a base erosion test must be satisfied. That is, the gross income of the entity must not be used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) other than to persons that meet any of the other limitation on benefits tests (other than the active business test) or who are U.S. citizens. This provision would, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends, interest or royalties to a Spanish company that is owned by individual residents of a third country.

An alternative is provided to persons that do not satisfy any of the seven tests previously discussed. Under this alternative, a person may demonstrate to the competent authority of the country in which the income arises that such person should be granted the benefits of the proposed treaty. According to the proposed treaty, one of the factors that is to be taken into consideration by the competent authorities in such cases is whether the establishment, acquisition, and maintenance of such person and the conduct of its operations did not have as one of its principal purposes the purpose of obtaining benefits under the proposed treaty. The burden of overcoming the treaty shopping rule, as under U.S. tax law generally, is on the taxpayer claiming treaty benefits.

Article 18. Directors' Fees

The proposed treaty contains a special rule for directors' fees. If an individual who is a resident of one country serves as a member of the board of directors of a company that is a resident of the other country, the country of the company's residence may tax him or her to the extent that the director's fees and similar payments derived by that person are attributable to services performed outside of the country of the individual's residence. This rule also

covers payments for services substantially equivalent to those provided by the board of directors of a company. This rule follows the OECD model, except that under the OECD model, income from services performed as a director in the individual's country of residence for a company that is resident in the other country is taxable by the latter country. There is no corresponding rule in the U.S. model treaty.

Article 19. Artistes and Athletes

The proposed treaty contains an additional set of rules which apply to the taxation of income earned by entertainers (such as theater, motion picture, radio or television "artistes" or musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 15 and 16) and are intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under the proposed treaty, one country may tax an entertainer or athlete who is a resident of the other country on the income from his personal activities as an entertainer in that country during any year unless the gross receipts that he or she derives from such activities, including reimbursed expenses, does not exceed $10,000 or its equivalent in Spanish pesetas for the taxable year. (The comparable amount in the U.S. model treaty is $20,000.) Thus, if a Spanish entertainer maintained no fixed base in the United States and performed (as an independent contractor) for two days in one taxable year in the United States for total compensation of $10,000, the United States could not tax that income. If, however, that entertainer's total compensation were $11,000, the full $11,000 (less appropriate deductions) is subject to U.S. tax. As in the case of the other provisions dealing with personal services income, this provision does not bar the country of residence from also taxing that income (subject to a foreign tax credit).

Provision 14 of the proposed protocol states that the $10,000 threshold does not preclude the source country from imposing withholding taxes on income of artistes and athletes, if such imposition is sanctioned under that country's domestic laws. To the extent that the amount of tax withheld in such a case exceeds the actual amount of tax due, such excess will be refunded to the taxpayer after the close of the taxable year.

In addition, the proposed treaty provides that where income in respect of personal services performed by an entertainer or athlete accrues not to the entertainer or athlete but rather to another person or entity, that income is taxable by the country in which the services are performed in any situation where the entertainer or athlete shares directly or indirectly in the profits of the person or entity receiving the income. (This provision applies notwithstanding Articles 7 and 15.) For this purpose, participation in the profits of the recipient of the income includes (without limitation) the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. The provision does not apply if it is established that neither the entertainer or athlete, nor related persons, participate directly or indirectly in the profits of the person or entity receiving the income in any manner. This pro-

vision is intended to prevent highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or trust located in a country that would not tax the income.

Notwithstanding the above provisions, the proposed treaty provides that income derived by a resident of one of the countries as an entertainer, musician, or athlete is exempt from tax by the other country if the person's visit to the other country is substantially supported by public funds of his or her country of residence (or of a political subdivision or local authority thereof). It is understood by the Treasury Department that the competent authorities may consult in determining which visits qualify for this exception.

The artistes and athletes article is subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States may tax its citizens and residents on income earned as an entertainer or athlete without regard to the provisions contained in the proposed treaty. For example, in the case of such income earned by a U.S. citizen resident in Spain, the U.S. tax on that income is not limited by the rules contained in Article 19.

Article 20. Pensions, Annuities, Alimony, and Child Support

Under the proposed treaty, pensions and other similar remuneration derived and beneficially owned by a resident of either country in consideration of past employment are subject to tax only in the recipient's country of residence. (A different rule applies in the case of pensions that are paid to citizens of one country attributable to services performed by the individual for government entities of the other (Article 21 (Governmental Service)). The saving clause allows each country to continue to tax its citizens who are residents of the other country on pensions and similar remuneration.

Payments under the Social Security legislation of one country and similar public pension payments made to a resident of the other country or to a U.S. citizen are taxable by the country making such payments, as well as by the country of residence. According to provision 15 of the proposed protocol, this rule equally applies to pensions paid from publicly administered funds for nongovernmental services (such as payments from the Railroad Retirement Accounts in the United States).

The proposed treaty also provides (subject to the saving clause) that annuities are taxed by only the country of residence of the person who beneficially derives them. Annuities are defined as stated sums paid periodically at stated times during a specific time period, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

The proposed treaty provides that alimony paid to a resident of one of the countries is taxable only by that country. The saving clause applies to alimony payments, so that the United States can tax such payments made to U.S. citizens resident in Spain. The proposed treaty defines alimony to mean periodic payments made pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support that are taxable to the recipient under the laws of his or her country of residence.

The proposed treaty provides that child support payments paid by a resident of one of the countries to a resident of the other country are taxable only in the country of the payor's residence. The proposed treaty defines child support to mean periodic payments made pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support for the support of a minor child. The saving clause would not apply to child support payments, so that the United States could not tax such payments made by Spanish residents to U.S. citizens or residents. Similarly, the child support rule in the U.S. model is not subject to the saving clause.

Article 21. Government Service

The proposed treaty contains the standard provision that generally exempts the wages of employees of one of the countries from tax by the other country.

Under the proposed treaty, remuneration, other than a pension, paid by a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) generally is taxable only in that country. Such remuneration is taxable only in the country of performance (the country not the payor), however, if the individual is a resident of the country of performance who either (1) is a citizen of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. Thus, for example, Spain would not tax the compensation of a U.S. citizen and resident (not a Spanish citizen) who is in Spain to perform services for the U.S. Government, and the United States would not tax the compensation of a Spanish citizen and resident (not a U.S. citizen) who performs services for the Spanish Government in the United States.

Any pension paid by, or out of funds created by, a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) generally is taxable only in that country. However, such pensions are taxable only in the other country if the individual is both a resident and a citizen of that other country.

In the situations described above, the U.S. model treaty allows exclusive taxing jurisdiction to the paying country, but only in the case of payments to one of its citizens.

If a country or one of its political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature) the provisions of Articles 15 (Independent Personal Services), 16 (Dependent Personal Services), 18 (Directors' Fees), 19 (Artistes and Athletes) and 20 (Pensions, Annuities, Alimony, and Child Support) apply, as appropriate, to remuneration and pensions for services rendered in connection with the business.

The provisions of the proposed treaty relating to government service are subject to the provisions of the modified saving clause (Article 1, paragraphs 3 and 4). That is, the general saving clause would apply except with respect to individuals who are neither citizens of, nor have immigrant status in, that country. With respect to the United States, the modified saving clause applies only to U.S. citizens and persons having immigrant status in the United States (i.e., "green card" holders).

Article 22. Students and Trainees

Under the proposed treaty, an individual who is a resident of one of the countries at the beginning of his visit to the other country and who is temporarily present in that other country for the primary purpose of studying at a university or other accredited educational institution in that other country, securing training required to qualify him or her to practice a profession or professional specialty, or studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization is exempt from tax in that other country for a period not to exceed five years from the date of his or her arrival in that other country. The exemption is subject to certain specifications, however. The exemption applies with respect to payments from abroad, other than compensation for personal services, for the purpose of the person's maintenance, education, study, research, or training. In addition it applies to grants, allowances, or awards, as well as to income from personal services performed in that other country in an aggregate amount not in excess of $5,000 (or its equivalent in Spanish pesetas) for any taxable year.

Similar rules are provided under the proposed treaty with respect to trainees. A special tax exemption applies to an individual who is a resident of one of the countries at the beginning of his or her visit to the other country and who is temporarily present in that other country as an employee of, or under contract with, a resident of the first-mentioned country, for the primary purpose of either acquiring technical, professional, or business experience from a person other than that employer (or person with whom he or she is under contract), or studying at a university or other accredited educational institution in that other country. In such cases, the person is exempt from tax by that other country for a period of up to 12 consecutive months with respect to income from personal services in an aggregate amount of no more than $8,000 (or its equivalent in Spanish pesetas).

The proposed treaty specifies that the above rules do not apply to income from the performance of research, if the research is undertaken not in the public interest, but primarily for the private benefit of a specific person or persons. Provision 16 of the proposed protocol clarifies that the monetary limits specified above ($5,000 and $8,000) include any amount excluded or exempted from taxation under the laws of the country in which the income is earned (e.g., these amounts would include the $2,000 personal exemption provided under section 151 of the Code).

The students and trainees article of the proposed treaty is subject to the provisions of the modified saving clause (Article 1, paragraphs 3 and 4). That is, the general saving clause applies except with respect to individuals who are neither citizens of, nor have immigrant status in, that country. With respect to the United States, the modified saving clause applies only to U.S. citizens and persons having immigrant status in the United States (i.e., "green card" holders). Thus, for example, the provisions of Article 22 which exempt a resident of Spain from taxation as a student or trainee in the United States are overridden by the saving clause if

that person is either a citizen of the United States or holds a green card.

Article 23. Other Income

This article is a catch-all article intended to cover items of income not specifically covered in other articles, and to assign the right to tax third-country income to only one of the countries. It applies to income from third countries as well as income from the United States and Spain.

As a general rule, items of income not otherwise dealt with in the proposed treaty that are derived by residents of either country are taxable only by the country of residence. In general, the proposed treaty thus gives the United States the sole right to tax income arising in a third country and paid to a resident of the United States. If the income is attributable to a permanent establishment or fixed base in the treaty country that is not the residence country, however, that country may also tax it. In addition, income from real property that is not subject to another treaty provision is taxable only in the country of residence of the person earning the income, whether or not the real property income is attributable to a permanent establishment or fixed base in the other treaty country. The effect of this provision is to allow the residence country to tax income from real property located in a third country, even if that income somehow is attributable to a permanent establishment or fixed base in the treaty country not of residence.

This provision is subject to the saving clause, so U.S. citizens who are Spanish residents would continue to be subject to U.S. taxation on their worldwide income.

Article 24. Relief from Double Taxation

Background

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may is subject to tax in the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax only on foreign source income. This limitation generally is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for oil and gas extraction income, passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income.

Foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction). However, no such limi-

tation will be imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met. The 90-percent alternative minimum tax foreign tax credit limitation, enacted in 1986, overrode contrary provisions of then-existing treaties.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation when dividends are received by the U.S. corporation from the foreign corporation, (the "indirect foreign tax credit). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of taxes to be credited, subject to the various separate limitation categories. However, if the foreign corporation is not a controlled foreign corporation (Code sec. 957), then the dividends received from it, and the foreign taxes attributable thereto, are included in a separate foreign tax credit limitation category.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person is taxable on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double taxation problem is dealt with in other articles of the proposed treaty that limit the right of a source country to tax income. This article provides further relief where both Spain and the United States would still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence waives its overriding taxing jurisdiction to the extent that this article applies.

The proposed treaty provides separate rules for relief from double taxation for the United States and Spain. In addition, it provides special rules covering U.S. citizens resident in Spain.

United States

The proposed treaty contains a provision like that found in many U.S. income tax treaties that the United States will allow a U.S. citizen or resident a foreign tax credit for income taxes paid to Spain. The credit is to be computed in accordance with the provisions of and subject to the limitations of U.S. law (as those provisions and limitations may change from time to time without changing the general principles of the credit).

The proposed treaty also allows the U.S. indirect foreign tax credit (Code sec. 902) to a U.S. corporate shareholder of a Spanish corporation receiving dividends from that corporation if the U.S. company owns 10 percent or more of the voting stock of the Spanish corporation. The credit is allowed for Spanish income taxes paid by or on behalf of the Spanish corporation on the profits out of which the dividends are paid.

Spain

The proposed treaty generally provides that in taxing a Spanish resident, Spain may include in its tax base income that the United States may tax under the proposed treaty, but that if Spain does so, it must allow as a deduction from Spanish tax on the income (i.e., as a credit) an amount equal to the income tax actually paid in the United States. This deduction is not to exceed, however, the portion of the Spanish tax, as computed prior to the deduction, which is attributable to the income from the United States. In effect, Spain would limit its foreign tax credit on a per-country basis with respect to the United States under the proposed treaty.

If a dividend is paid by a U.S. company to a company resident in Spain which owns at least 25 percent of the capital of the U.S. company making the distribution,[16] an indirect foreign tax credit is permitted, which operates in a manner similar to the U.S. indirect credit under Code section 902. That is, in addition to taxes paid directly by the recipient of the dividend, the portion of taxes paid by the distributing U.S. company attributable to the profits out of which the dividend is paid is deemed paid by the recipient Spanish company and is available for the foreign tax deduction allowed under the proposed treaty. The recipient company must also gross up the amount of the dividend received by the amount of foreign taxes it is deemed to have paid under this rule. As is the case with direct foreign taxes, the amount of the foreign tax deduction allowable for indirect taxes may not exceed the portion of the pre-deduction Spanish tax that is attributable to the income subject to tax in the United States.

The proposed treaty further provides that in situations where, in accordance with other provisions of the treaty, income derived or capital owned by a resident of Spain is exempt from Spanish tax, Spain is permitted to take such income or capital in account in computing the amount of tax on the remaining income or capital of that person. In such a case, Spain will determine the average rate of tax applicable as if the total income (including exempt income) were taxable and apply that rate to the taxable portion of the total income.

Source rules

In this article, the proposed treaty also provides source rules for determining when an item of income arises in one of the countries with respect to an individual who is a citizen of the United States and a resident of Spain. These source rules are used for the purpose of allowing relief from double taxation under this article. Such persons are entitled to a credit against U.S. tax liability in the amount of the Spanish tax paid. Thus, Spain generally would have primary residence taxing jurisdiction over the income of such persons, and the United States would deem the income that Spain taxes on this basis to arise in Spain (for the limited purpose of

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[16] For this purpose, the proposed treaty requires this threshold of ownership to be maintained on a continuous basis during the taxable year in which the dividends are paid as well as during the previous taxable year. If the company paying the dividend was created in such previous taxable year, provision 17 of the proposed protocol clarifies that the previous taxable year is deemed to commence on the date of creation of the company.

crediting these Spanish taxes). This U.S. tax credit is not to reduce U.S. taxation on a source basis of such a person's U.S. source income. This rule will not operate to increase such a person's U.S. foreign tax credit limitation so as to enable him or her to credit any additional non-Spanish taxes.

For situations other than the one specified in the preceding paragraph, the treaty does not provide specific sourcing rules for purposes of determining relief from double taxation.

Article 25. Non-Discrimination

The proposed treaty contains a non-discrimination provision relating to the taxes covered by the treaty similar to provisions which are embodied in other recent U.S. income tax treaties. This non-discrimination provision applies not just to the taxes that the treaty covers generally, but to all taxes that either country or any of its political or administrative subdivisions or local authorities impose.

In general, under the proposed treaty, one country cannot discriminate by imposing more burdensome taxes (or requirements connected with taxes) on nationals of the other country than on its own nationals in the same circumstances. This provision applies whether or not those nationals are residents of the United States or Spain. For the purposes of U.S. tax, however, a U.S. national who is not a resident of the United States and a Spanish national who is not a resident of the United States are not in the same circumstances, because the U.S. national is subject to U.S. tax on his or her worldwide income.

The proposed treaty adopts the OECD model treaty definition of nationals. Nationals are individuals possessing the citizenship of the United States or Spain and all legal persons deriving their status as such from the laws in force in the United States or Spain. Under the U.S. model treaty, by comparison, only U.S. citizens qualify as U.S. nationals for purposes of obtaining non-discrimination benefits.

Similarly, in general, one country cannot impose less favorable taxes on permanent establishments of enterprises of the other country than it imposes on its comparable enterprises. However, a country need not grant to residents of the other country the personal allowances, reliefs, or reductions for taxation purposes on account of civil status or family responsibilities that it grants to its own residents.

The proposed treaty clarifies that nothing in the article on non-discrimination is construed as preventing either country from imposing a branch profits or branch interest tax.

Each country is required (subject to the arm's-length pricing rules of Articles 9 (Associated Enterprises), 11(7) (Interest), and 12(6) (Royalties)) to allow an enterprise to deduct interest, royalties, and other disbursements paid by the enterprise to a resident of the other country under the same conditions that they allow deductions for such amounts paid to residents of the same country as the payor.

The rules concerning non-discrimination also apply to enterprises of one country which are owned in whole or in part by residents of the other country. An enterprise resident in one country,

the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, is not to be subject in the country of its residence to any taxation or any connected requirement which is more burdensome than the taxation and connected requirements that the country of its residence imposes or may impose on its enterprises carrying on the same activities but the capital of which is owned or controlled by its residents.

The saving clause (which allows the country of residence or citizenship to tax notwithstanding certain treaty provisions) does not apply to this non-discrimination article.

Article 26. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision which authorizes the competent authorities of both the United States and Spain to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in waiver (otherwise mandated by a substantive provision of the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Generally, under the proposed treaty, a person who considers that the action of the countries or either of them will cause him to pay a tax not in accordance with the treaty may present his case to the competent authority of the country of which he is a resident or national. In such an instance, the case must be presented within five years from the first notification of the action resulting in taxation not in accordance with the provision of the proposed treaty. For this purpose, provision 18 of the proposed protocol specifies that the term "first notification" means, in the case of the United States, the Notice of Deficiency as provided for under Code section 6212. In the case of Spain, it means the Notification of the Administrative Act of Assessment. For both countries, with respect to taxes at source, the term means the date on which the tax is paid or withheld.

Upon notification, the competent authority makes a determination as to whether the objection appears justified. If the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, then that competent authority would endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the Convention. The provision requires the waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations. The provision, however, does not authorize the imposition of additional taxes after the statute of limitations has run.

The competent authorities of the Contracting States are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation of application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the proposed treaty. In particular, the proposed treaty provides that the competent authorities may con-

sult with one another to reach agreement on the application of the limits imposed on the taxation at source of dividends, interest, and royalties by the respective articles covering those topics (Articles 10, 11, and 12).

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of the mutual agreement provisions. These provisions make clear that it is not necessary to go through standard diplomatic channels in order to discuss problems arising in the application of the treaty and also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Spain.

Article 27. Exchange of Information and Administrative Assistance

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to enable them to obtain information so that they can properly administer the proposed treaty. The proposed treaty provides for the exchange of information which is necessary to carry out its provisions or the provisions of the domestic laws of the two countries concerning taxes covered by it insofar as the taxation under those domestic laws thereunder is not contrary to the proposed treaty. In addition, the competent authorities may exchange such information as is necessary to prevent tax evasion or fraud, so long as the tax is covered by the proposed treaty and the resulting taxation is not contrary to it. The exchange of information is not restricted by Article 1 (General Scope). Therefore, the countries could exchange information about third country residents. The proposed treaty, like the U.S. model treaty, provides for the exchange of information about all taxes imposed by either country (whether or not otherwise covered by the treaty).

Any information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. Exchanged information is to be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the treaty. Such persons or authorities could use the information for such purposes only, but may disclose the information in public court proceedings or in judicial decisions. It is understood that this provision permits access to taxpayer information to legislative bodies involved in the oversight of the administration of taxes, as well as to their agents. For example, this would cover the U.S. General Accounting Office when it is engaged in a study of the administration of the tax laws pursuant to a Congressional request.

Under the proposed treaty, a country is not required to carry out administrative measures at variance with the laws and administrative practice of either country, to supply information which is not obtainable under the laws or in the normal course of the administration of either country, or to supply information which would disclose any trade, business, industrial, commercial, or professional

secret or trade process, or information the disclosure of which would be contrary to public policy.

Provision 19 of the proposed protocol provides that the article on exchange of information and administrative assistance is to be interpreted consistently with the Commentary on the OECD model treaty with respect to the similar article contained in that treaty. In addition, that provision of the proposed protocol states that the competent authorities of the two countries shall, even without being requested to do so, exchange such information as is necessary to ensure that the benefits of the proposed treaty are applied only to those persons who are entitled under the treaty to receive them. Unlike the U.S. model treaty, however, the proposed treaty does not require a country to endeavor to collect any tax on behalf of the other for this purpose.

Article 28. Diplomatic Agents and Consular Officers

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the proposed convention will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country.

The saving clause (as modified by paragraph 4(b) of Article 1) does not apply to this article, so that, for example, U.S. diplomats who are considered Spanish residents are not subject to Spanish tax.

Article 29. Entry Into Force

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country and the instruments of ratification are to be exchanged as soon as possible in Washington. In general, the proposed treaty will enter into force when the instruments of ratification are exchanged.

With respect to taxes withheld at source (i.e., taxes on dividends, interest, and royalties), the treaty will be effective for amounts paid or credited on or after the first day of the second month next following the date on which the treaty enters into force. With respect to other taxes, the treaty is to be effective for taxable periods beginning on or after January 1 of the year following the date on which the treaty enters into force.

Provision 20 of the proposed protocol contains a rule requiring the competent authorities of the two countries to consult together regarding the appropriateness of negotiating any modification of the proposed treaty to reflect subsequent substantial changes in the domestic legislation of either country or in their tax relations with third countries. Need for such negotiations might be provoked either by new developments in one of the country's tax treaty negotiating policy or as a consequence of changes which may occur in the supranational systems of integration to which the two countries are parties. For example, if one of the countries revised its treaty policy with respect to rates of withholding taxes, the competent authorities would consult regarding the possibility of extending that revised policy to this treaty.

Article 30. Termination

The proposed treaty will continue in force indefinitely, but either country may terminate it at any time after five years from its entry into force. Notice of termination must be made through diplomatic channels, and given at least six months before the end of a calendar year.

If termination occurs, it will be effective for taxes chargeable for any taxable year beginning on or after the first day of January in the calendar year next following the year in which notice is given.